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TO EXAMINE SMALL BUSINESS TRADE OPPORTUNITIES WITH THE SOVIET UNION AND EASTERN EUROPE

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

TO EXAMINE SMALL BUSINESS TRADE OPPORTUNITIES WITH THE SOVIET UNION AND EASTERN EUROPE

MARCH 23, 1990

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HEARING DATE

March 23, 1990:

Morning session 1

TO EXAMINE SMALL BUSINESS TRADE OPPORTUNITIES WITH THE SOVIET UNION AND EASTERN EUROPE

FRIDAY, MARCH 23, 1990

U.S. Senate,
Committee on Small Business,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m., in room SR-428A, Russell Senate Office Building, Hon. Joe Lieberman presiding.

STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Lieberman**. I would like to welcome everyone here this morning to this hearing of the Small Business Committee on opportunities for American business, and we have a particular focus in this Committee on small business, in Eastern Europe, including the Soviet Union.

We are honored today to have three outstanding panels of witnesses with representatives from Government, the private sector, and experts in the field of Eastern European and Soviet economic affairs, and we are very grateful to them for being here.

It has in some senses become trite for us to say that there are extraordinary changes that have occurred in Eastern Europe, but it is still so relatively recent that it never hurts to emphasize that there have been extraordinary changes in Eastern Europe.

I find here in Washington and back home as well that these changes have evoked two different kinds of reactions. Everybody is excited about them, but some feel that because of the limitation on our own resources here in this country, the best that we can do is to sit back and watch events unfold.

Others—and I would like to believe that those others are certainly in the majority here—believe that this is an extraordinary opportunity for America to play a leadership role in the events that are going on in Eastern Europe and to try to move them in a direction that is good for the world, good for America, and good for American business.

We have a moral obligation to do so because of all that we have done to encourage the peoples of Eastern Europe to reach out for their freedom and because of all that we have meant to them.

This is the beginning of my second year as a Senator, and I think the most electric, compelling moment of my first year was the speech that Lech Walesa made to us last year. I was struck by the extent to which he said that the American ideal, the American system, economic and political, was what motivated and inspired and sustained him and so many others who fought for freedom in Poland during all those years.

And I think that really gives us a moral obligation. But this is also an economic opportunity. There are extraordinary opportunities for us to help stabilize and bring growth to the newly emerging free economies of Eastern Europe, and I hope and believe that there are extraordinary opportunities for American business to participate in that process to the benefit of Eastern Europe, but also to the benefit of the American economy.

I understand that it is not an uncomplicated opportunity facing American business in Eastern Europe, but I hope that we in Congress can play a leadership role in trying to open up those opportunities, as well as to support the development of those new economies.

I introduced legislation yesterday that I believe would be of help to both the private sector in Eastern Europe and the private sector here in America wanting to do business in Eastern Europe.

Let me very briefly touch on a few of the points in the legislation.

The bill that I have put in would establish an Eastern European Economic Strategy Planning Commission so our Government can develop a long-range strategy with the American public and private sectors to aid the nations of Eastern Europe in their development of market-based economies and to aid our businesses to participate in those economies.

Second, it would establish an Eastern European foundation, patterned on the existing Inter-American Foundation, which would provide grant money and technical assistance to Eastern European small- and mid-sized businesses and entrepreneurs.

Third, this is one where the facts have moved ahead of the requests, I am pleased to say, when we drafted the bill we repeated a request that I had made earlier in an amendment submitted last year to the SEED 1 bill asking the Secretary of State to enter into negotiations with other members of the OECD to establish an East-West Economic Transition Center at the OECD. I am happy to say that just last week the OECD agreed to create such a center.

The bill would also authorize an appropriation to increase the number of economic and commercial officers in American embassies and consulates in Eastern Europe and the Soviet Union to give tangible support to the involvement of American business in those areas.

The bill would also recycle Soviet repayment of lend-lease debt which we hope will occur as part of a Soviet-American trade agreement. That money would be used for joint U.S.-Soviet and U.S.-East European projects.

The bill would also establish an intensive managerial business and finance training program for business people and entrepreneurs in Eastern Europe.

And, finally, it would express the sense of Congress in support of increased funding for Ex-Im Bank which I think is critical for helping American business as it tries to enter the new markets of Eastern Europe.

In today's hearing there are a number of topics that will surely touch on some of the proposals contained in my legislation. Specifically, each panel has been asked to cover certain aspects of the problem and prospects of doing business with Eastern Europe and the Soviet Union.

The first panel, the Government panel, has been asked to describe the amount of potential and existing trade between the United States and the nations of Eastern Europe, the existing trade and commercial agreements between the United States and these nations, investment and export opportunities for American business, the Government programs that are now available to support American business in this effort, and also how firms from other nations, particularly the Japanese and West Germans, are approaching the changes in Eastern Europe.

The second panel is a panel of business leaders who we have asked to address some of the same questions, including how they view the investment and export opportunities for American firms in Eastern Europe, what they view as the Federal Government role in supporting those opportunities, and a description of the personal experiences that they have had in doing business in Eastern Europe.

And, finally, our panel of Soviet and East European specialists has been asked to describe the present state of the economies of Eastern Europe, whether the political and economic changes that are occurring now are reversible, and what the Federal Government can do to ease and support this transition to market-based economies. I would also like them to comment on how they view the opportunities for American business in Eastern Europe and the Soviet Union.

I have been over the testimony presented by the three panels of witnesses, and I must say that I have never seen more thoughtful, more valuable testimony submitted for a hearing. The record of this hearing will have practical use, particularly for American business people who want to go into Eastern Europe but wonder whether they should. I thank the witnesses for the quality of that testimony.

Before I call on the witnesses, I welcome my colleagues, Senators Pressler and Burns, and would yield now to Senator Pressler for an opening statement.

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator Pressler. Thank you very much, Mr. Chairman.

I believe very strongly that this hearing today is extremely important to small businesses across the United States. I have been interested in small business trade opportunities throughout the world, and there are a lot of small businesses from my State that do carry on international activities.

But a lot of small businesses do not know about the opportunities. They do not have law firms or accounting firms or consultants to advise them how to go about it. They are not accustomed to traveling. But as EC 1992 approaches and as Eastern Europe and the Soviet Union opens up, so to speak, our small businesses are the ones who will do the bulk of the exporting when it is all said and done.

I was amazed once to walk into a trade fair in Canton, China, and see little Scotsman Industries from South Dakota having a display. Last week I was in Watertown, SD, and there is a company that is planning a major effort in EC 1992. So there are small businesses doing it, but they have a particularly difficult time knowing of the opportunities and being able to make the first step. I hope today the witnesses will also emphasize how a small businessman who wants to export or trade gets into the situation, how they get going, and what sort of assistance and information is available because that is a very important part.

In the 90's our small businesses are going to be the engine of our economy. They are going to provide the majority of our employment, and we have got to get them involved in this show over there in Eastern Europe and the Soviet Union.

Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Pressler.

Senator Burns, do you have an opening statement?

STATEMENT OF HON. CONRAD BURNS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BURNS. Thank you, Mr. Chairman. Just a short statement.

I have always said that we probably need some assistance in the hinterlands where Senator Pressler and I come from on developing some sort of an entry into foreign markets.

And so I guess what I am looking for out of this testimony is how can we use the expertise that has been developed in the private sector. Also we want to learn how we apply that into some of the programs that government has sort of taken on or wants to take on the responsibility of carrying out.

We come from an agricultural state, and we do an awfully good job, I think, with the new grain agreement that has just been signed with the USSR. We ship the raw product, but I think we ought to be in the business of shipping a value-added product to provide jobs here in the United States. We should take a little more of what we produce, add a value to it before it finally gets to the end user. That has been the basis of our economy here in this country.

And I guess what I am looking for today is that whenever people come in and advise agencies on what path we should be taking, I am wondering if that advice falls on deaf ears or what we are doing about that.

And I have looked over some of the statements, not all of them, so I will be interested in asking some questions, and they may be kind of pointed because I just do not think right now that we are doing enough in that area, but I am not real sure what the role of the Government is in that.

In other words, I think maybe the role of the Government is just open the gate, and let a damn good salesman go over there and sell this product. Sometimes where the keeper of the gate is the Government and they do not want to open it up because somebody will lose their job over the deal. I am running into that all the time. So, thank you, Mr. Chairman, that is what I am listening for is what the people standing at the gate are doing to let some of this entrepreneurial spirit carry over into Eastern and Central Europe. Thank you very much.

Senator LIEBERMAN. Thank you, Senator Burns.

Senator Grassley, would you like to make an opening statement?

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Thank you, Senator. I appreciate very much your leadership in this area, and I know holding hearings on Friday is a burden for a lot of people. I appreciate the fact that you are willing to give your time today because we probably will not be interfered with quite as much as we would be during the week when we have so many votes and other Committee meetings. I want to commend you for holding this hearing to look at a very important issue.

We want to examine Soviet and Eastern European trade opportunities for our Nation's small businesses. Every day as the Communist nations of Eastern Europe and the Soviet Union evolve into democratic societies, new markets open for American business.

Our goal today is to discuss how small business can participate in these markets and what the Federal Government can do and are already doing to assist their participation.

I have recently introduced the Agricultural Export Enhancement Act, S. 2266, which seeks new markets for agricultural products. I believe that we should assist small agribusinesses in expansion and development overseas. This legislation aids that process by establishing new market research, loan programs, and a new market task force. American processors can export to new markets if they know the demand, the cultural barriers, and the mechanics of dealing with a new country. This is especially true for the markets of the Soviet Union and Eastern Europe.

Conducting this research is risky for small businesses, and many do not have the necessary time or capital to take the risk.

The Market Research Loan Program that I propose is designed to minimize this risk to American processors so they can venture into new markets without fearing financial ruin.

In addition to private market research, a great deal of information is collected by the U.S. Government which could aid export-minded processors of small businesses. The Foreign Agriculture Service, the U.S. Trade Representative, and the Commerce Department all have information which could be useful to small U.S. businesses. We need to coordinate an effort to compile and disseminate this information to people who can use it, and our Nation's small businesses are surely people who can use that business.

While the Agricultural Export Enhancement Act is aimed at helping Ag processors, many of which are small businesses. I also believe that the new Market Research Loan Program and the new Market Task Force will help many other small businesses learn of business opportunities abroad.

Mr. Chairman, I am very interested in learning of the programs which are available to our Nation's small businesses to assist them in taking advantage of new markets in Eastern Europe and the Soviet Union. I particularly want to encourage all of our departments, particularly if there is a necessity for a close working relationship between, let us say the Small Business Administration and State Department, that there be maximum cooperation. That is essential from the standpoint of speed of communication and speed of decision making in the process, so that each of the departments can maximize their efforts under the available resources to make sure that our private sector can serve and respond to this opportunity in Eastern Europe.

I thank you, Mr. Chairman, for holding this hearing. I think that this Committee meeting is an important part of the dialogue.

Senator LIEBERMAN. Thank you, Senator Grassley.

I welcome Senator Kasten of Wisconsin and look forward to his opening statement at this time.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you very much.

Over the past year the world watched with amazement as rapid and dramatic change took place in Eastern Europe and the Soviet Union. A dramatic revolution occurred in a place where democracy had previously been most brutally suppressed. It was inevitable that economic change would closely follow political change, and nations throughout the world are now re-examining potential trade with Eastern Europe.

Today's hearing will play a vital role in that regard, and I believe that Congress must ask itself at least two things: First, are we ready for the dramatic liberalization and expansion of our trading relationship with the Soviet Union and Eastern Europe and, second, what type of relationship should be forged. Exactly what should our resources be focused upon and what kind of mechanisms with regard to our Government and our private sector are going to be brought to bear.

I simply want to say, Mr. Chairman, I think it is an important hearing that we are having today because as we begin our trade efforts, I already see conflicts and rivalries between different departments that are involved in trade, and we also have an important role for everyone from private sector volunteer groups in Milwaukee, WI, to Rotary International—there are just a whole number of people that are trying to be part of this.

And if we are not speaking with one voice, in effect having a one-stop shop here in Washington, we are going to be in a lot of trouble trying to deal with the thousands of people across this country who are trying to make a difference, trying to make a contribution. This hearing is very important, and I thank you very much for having it.

[The prepared statements of Senators Bumpers, Boschwitz, and Dixon follow:]

Statement of Sen. Dale Bumpers

March 23, 1990

I want to commend Sen. Joe Lieberman for taking the initiative to request and put together this hearing this morning on small business trade opportunities in Eastern Europe. The timing could hardly be more opportune for both businesses and the government to begin to examine the many challenges which the tumultuous events of the last few months present.

It has become trite to say that we stand at the crossroads of history; some have even called it the end of history. If you believe Karl Marx, it probably is the end of history in more ways than one. The failure of communism and the command economy is complete. Lenin has been called the God that failed. And hardly anyone could have anticipated that this sequence of events would have come about so quickly.

Nonetheless, we now face an Eastern Europe which is utterly on its knees economically, but which extends open arms toward the West. Both the United States government and American business have a moral obligation to help these countries as best we can to reach the level of development which they so desperately seek. It is, after all, the magnificent productivity of American business, perhaps more than anything else, which has caused the ultimate collapse of socialism. I believe this is so because, to turn Khruschev's infamous words around, we have simply buried them. Market economies have so outproduced the command economy in the last forty years that even the staunchest dictators could no longer maintain the fiction of competition. Our abundance, as well as our political liberties, were so apparent that the communists themselves could no longer maintain their faith.

There remain, however, enormous obstacles to American firms seeking to trade with Eastern Europe, to say nothing of the Soviet Union. There are more than the usual problems of finance, insurance, export barriers and basic logistics. We must identify potential markets for our goods as well as helping those countries to sell their products here so that they will have the foreign exchange to purchase Western goods. None of these matters is simple, and we need all the expertise that can be mustered by both business and government.

I look forward to hearing the testimony of this morning's distinguished panel of experts.

STATEMENT OF SENATOR RUDY BOSCHWITZ
HEARING ON OPPORTUNITIES FOR SMALL BUSINESSES TO TRADE WITH EASTERN EUROPE AND THE SOVIET UNION
MARCH 23, 1990

THANK YOU, MR. CHAIRMAN, FOR CONDUCTING THIS HEARING ON WHAT POSSIBLE OPPORTUNITIES MAY EXIST FOR UNITED STATES SMALL BUSINESSES TO TRADE WITH THE SOVIET UNION AND EASTERN EUROPE.

THE EVENTS OF THE PAST FEW MONTHS IN EASTERN EUROPE AND THE SOVIET UNION HAVE BEEN REMARKABLE. WITH THE DISSOLUTION OF COMMUNISM AND THE ONSET OF CAPITALISM IN MOST OF THE EASTERN EUROPEAN COUNTRIES, IT IS NECESSARY THE UNITED STATES EXPLORE ALL TRADE OPPORTUNITIES IN THAT PART OF THE WORLD. IT IS ALSO IMPERATIVE THAT SMALL BUSINESSES LEARN TO COMPETE IN THOSE NEW, DEVELOPING TRADE MARKETS. WE MUST DIRECT PROPOSALS LEADING THIS NEW MARKET TOWARD U.S. SMALL BUSINESS PRODUCTS. SMALL BUSINESSES WILL ALSO NEED TO DEVELOP MARKETING AND PRODUCTION STRATEGIES TO ASSIST THEM WITH THESE POTENTIAL TRADING PARTNERS.

IN RESPONSE TO SECTION 8011 OF THE 1988 TRADE BILL, THE SMALL BUSINESS ADMINISTRATION (SBA) WILL BE CONDUCTING ITS NATIONAL SEMINAR ON SMALL BUSINESS EXPORTS NEXT WEEK (MARCH 27-30) IN SEATTLE. EXPORT EXPO 90, AS IT IS CALLED, WILL CONDUCT SEMINARS ON THE PROSPECTS OF TRADING WITH EASTERN EUROPE AND THE SOVIET UNION. THE SBA IS EXPECTING 231 SMALL BUSINESS EXHIBITORS TO PARTICIPATE IN EXPORT EXPO 90.

AS A RESULT OF THE SUPPORT FOR EAST EUROPEAN DEMOCRACY (SEED) ACT, THE FEDERAL GOVERNMENT IS WORKING TOGETHER TO DEVELOP A UNIFIED APPROACH TOWARD TRADING WITH THESE NEW CAPITALISTIC AREAS. THE SBA HAS SUBMITTED ITS PROPOSAL TO THE SEED COORDINATOR ON HOW SMALL BUSINESSES CAN INTERACT WITH EASTERN EUROPE. I AM INTERESTED IN HEARING WHAT OUR PUBLIC WITNESSES HAVE TO SAY ABOUT THIS UNIFIED APPROACH AND WHERE THEY BELIEVE SMALL BUSINESS FITS INTO THE PICTURE.

I HOPE WE CAN ALSO TAKE A RELOOK AT CURRENT U.S. GOVERNMENT RESTRICTIONS ON DOING BUSINESS IN EASTERN EUROPE, PARTICULARLY AS IT AFFECTS OUR SMALL BUSINESSES. I'M CONCERNED THAT WE MAY BE IMPOSING TOO MUCH PAPERWORK ON TRADERS. I THINK WE SHOULD BE REVIEWING OUR EXPORT CONTROLS TO ENSURE, IN THE EVOLVING POLITICAL AND ECONOMIC ENVIRONMENT IN EASTERN EUROPE, THAT WE COME UP WITH THE RIGHT BALANCE BETWEEN LEGITIMATE U.S. SECURITY NEEDS AND OUR INTEREST IN SELLING GOODS IN THESE POTENTIALLY VERY FRUITFUL MARKETS.

ANOTHER FACTOR WHICH COULD AFFECT THE DEVELOPMENT OF TRADING WITH EASTERN EUROPE IS EC92. BY 1992 THE TWELVE COUNTRIES OF THE EUROPEAN COMMUNITY WILL CREATE AN ECONOMIC AREA IN WHICH ALL BARRIERS WILL HAVE BEEN REMOVED AND THE PRINCIPLES OF SOLIDARITY WILL BE APPLIED, KNOWN AS EC92. THE PURPOSE IS TO RESTORE THE FIRMS OF THE EUROPEAN COMMUNITY TO ECONOMIC HEALTH AND TO A STRONG COMPETITIVE POSITION. IT WILL BE INTERESTING TO SEE WHAT

EFFECT EC92 WILL HAVE ON AMERICAN COMPANIES' EFFORTS TO TRADE WITH EASTERN EUROPE.

I WELCOME OUR DISTINGUISHED GROUP OF WITNESSES THIS MORNING AND LOOK FORWARD TO THEIR TESTIMONIES. I THANK YOU, MR. CHAIRMAN, FOR HOLDING THIS HEARING ON A MOST TIMELY SUBJECT.

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE SENATE SMALL BUSINESS COMMITTEE
ON
SMALL BUSINESS TRADE OPPORTUNITIES IN EASTERN EUROPE AND THE SOVIET UNION

MARCH 23, 1990

MR. CHAIRMAN, RECENT POLITICAL AND SOCIAL CHANGES IN EASTERN EUROPE AND THE SOVIET UNION HAVE OPENED PREVIOUSLY INACCESSIBLE BUSINESS MARKETS AND LABOR FORCES. THE ARRIVAL OF A MCDONALDS HAMBURGER RESTAURANT IN MOSCOW IS EVIDENCE THAT AMERICAN INDUSTRY HAS BEGUN TO TAKE ADVANTAGE OF IMPROVING AMERICAN-SOVIET RELATIONS.

THE SMALL BUSINESSMAN AND BUSINESSWOMAN DO NOT POSSESS THE SAME ABILITY TO TAKE ADVANTAGE OF THIS OPPORTUNITY AS DOES BIG BUSINESS. OPERATING ON SIGNIFICANTLY SMALLER REVENUE BASES AND WITHOUT THE LUXURY OF EMPLOYING INTERNATIONAL MARKETING STAFFS, THE SMALL BUSINESS COMMUNITY HAS LITTLE HOPE OF SUCCESSFULLY ENTERING OVERSEAS MARKETS. AT HOME, SMALL BUSINESS CONTINUES TO EXPERIENCE SHRINKING MARKET SHARES, SOME FROM TWO FRONTS -- FOREIGN COMPETITORS AND AMERICA'S FEDERAL PRISON INDUSTRIES. FOREIGN COMPETITORS ARE TAKING ADVANTAGE OF LOWER LABOR COSTS AND LESS RESTRICTIVE OFF SHORE MANUFACTURING REGULATIONS TO COMPETE AGAINST AMERICAN MADE PRODUCTS. IF THIS THREAT WASN'T ENOUGH, CERTAIN SMALL BUSINESSES HAVE TO COMPETE AGAINST FEDERAL PRISON INDUSTRIES, AND THEIR "SUPER-PREFERENCE" ADVANTAGE IN PROVIDING PRODUCTS TO THE GOVERNMENT.

IN ADDITION TO UNFAIR HEAD-TO-HEAD COMPETITION, THE SMALL BUSINESS COMMUNITY IS ALSO BEING BESIEGED BY EXPANDING REGULATIONS THAT INCREASE OPERATING COSTS AND EAT INTO PROFIT MARGINS. THE PENDING CLEAN AIR ACT WILL UNDOUBTEDLY BE THE STRAW THAT BREAKS THE BACK OF MANY SMALL BUSINESSES. ADD TO THE CLEAN AIR IMPACT POSSIBLE FUTURE LEGISLATION ON MANDATORY HEALTH CARE AND OTHER INITIATIVES THAT INCREASE COSTS AND REDUCES COMPETITIVENESS, AND THE RESULT IS THE LOSS OF MORE AND MORE SMALL BUSINESSES TO THE AMERICAN ECONOMY.

I FEEL THAT WITH THE PROPER ASSISTANCE AND SUPPORT, THE SMALL BUSINESS COMMUNITY CAN TAKE ADVANTAGE OF EMERGING FOREIGN MARKETS AND LABOR POOLS TO HELP OFFSET LOSSES DUE TO UNFAIR COMPETITION AND FISCALLY OPPRESSIVE REGULATIONS. IN THE AREAS OF FOREIGN COMPETITION AND FEDERAL PRISON INDUSTRIES, WE MUST CONTINUE TO SEEK SOLUTIONS THAT WILL RESULT IN A LEVEL PLAYING FIELD FOR AMERICAN BUSINESS.

I WOULD LIKE TO COMMEND THE CHAIRMAN FOR HOLDING TODAY'S HEARING AND I LOOK FORWARD TO THE TESTIMONY FROM OUR PANELISTS. HOPEFULLY, AT THE CONCLUSION OF OUR HEARING, THE SMALL BUSINESS COMMUNITY WILL HAVE A CLEARER VISION TOWARD FUTURE BUSINESS OPPORTUNITIES -- NOT ONLY IN THE SOVIET UNION AND EASTERN EUROPE, BUT IN ALL FOREIGN MARKETS.

Senator LIEBERMAN. Thank you, Senator. I think you struck just the right tone. I think there is tremendous energy and enthusiasm for helping the people of Eastern Europe. There are people who want to be involved, and just to pick up on what Senator Kasten said, maybe the main question we want to answer today is how can we productively channel the energies of people, and volunteers, who want to help the people of Eastern Europe, and at the same time, how can we help American firms wanting to do business there.

OK, with those invocations, I want to welcome the first panel, the Government panel. May I say again that all of the testimony that you have submitted will be printed in the record.

We are going to use the lights today, and I ask you to try to summarize your statements in a little more than 5 minutes if you can. If it is any consolation to you, we are going to impose the same light system on ourselves in our questioning of you.

So, we will begin with the Assistant Secretary of State for Economic and Business Affairs, Eugene McAllister.

STATEMENT OF HON. EUGENE J. McALLISTER, ASSISTANT SECRETARY OF STATE FOR ECONOMIC AND BUSINESS AFFAIRS, U.S. DEPARTMENT OF STATE, WASHINGTON, DC

Mr. McALLISTER. Mr. Chairman, Members of the Committee, I am delighted to be here today to discuss with you events in Eastern Europe, the Administration's response, and the implications for U.S. business, particularly small business.

These are extraordinary times, and the word that best characterizes them is "opportunity": Opportunity for freedom and democracy, opportunity for economic development, opportunity for U.S. business to participate in and help shape the new Europe.

There are three major points I would like to make:

1. The Bush Administration is pursuing a positive, anticipatory policy that links political and economic freedom with the successful transformation of Eastern European economies. Secretary Baker characterized this policy as "New Democratic Differentiation" in his address in Prague.

The essence of this policy is that we will provide assistance to those reforming governments to the extent that they continue to move in the direction of political and economic freedom.

2. We tend to use the phrase "Eastern Europe" to categorize the countries and their economies. However, each of these economies is very distinct, and faces different challenges and problems.

The Administration recognizes these differences, and that is one of the reasons that the President is seeking the flexibility to respond to change as it occurs and to be most effective in that response.

3. We at the State Department are convinced that U.S. business must be a critical part of our national response. U.S. business has a tremendous amount to offer the Eastern European nations as exporters of high quality, low cost consumer and intermediate products and as investors bringing in capital, technology, management, and above all else a stake in the success of the Eastern European nations.

Creating opportunities for U.S. business is a critical element of the President's response to the changing situation in Eastern Europe.

I would like to elaborate on these points and offer some remarks on economic change and opportunities in the Soviet Union.

Our policy of democratic differentiation represents a new direction in U.S. foreign policy. We will no longer expand our contacts with Eastern European governments to the extent that they differ from the Soviet Union. Instead, we will tailor our assistance to the needs of each of these countries as they move toward the following four objectives: Progress toward political pluralism; enhanced respect for internationally recognized human rights; progress toward economic reform; and a willingness to build a friendly relationship with the United States.

You can see this policy at work already. At the most basic level we are providing for short term emergency aid such as food and medicine in Poland and Rumania.

We are also taking a number of steps to promote political pluralism and to support the transition to market-oriented economies. These include: Technical assistance; cultural, educational and scientific exchange programs; environmental assistance; funding for democratic institutions; and for those countries that meet the requirements of U.S. law, normalization of bilateral trade and investment relations.

The President's legislative proposal, the "Eastern European Democracy and Free Market Act of 1990," is designed to meet the needs of the Eastern Europeans and, at the same time advance our national interests, including business interests. We want flexibility to respond where our assistance is wanted, and when it is needed.

The legislation includes a number of measures that would directly contribute to improving business conditions in Eastern Europe. It seeks the authority to: Extend the provisions of the 1989 SEED Act to other Eastern Europe countries and Yugoslavia; to extend MFN and GSP status those countries that meet the legislative requirements; and to permit OPIC to operate in the Eastern European countries. We have asked for $300 million for fiscal year 1991 and for the ability to adjust these expenditures among different programs as needed.

In addition to the legislative authority we are seeking, the Administration is going to aggressively use trade and investment agreements, the Ex-Im Bank and our leadership role in international financial institutions to respond.

Each of these nations is different, but they all are facing to some degree three general problems: Macroeconomic instability; the need for structural adjustment, including price reform; and current account imbalances and lack of hard currency. The fact that their total trade with the United States is less than ½ of 1 percent of total U.S. trade is in part due because of a lack of hard currency. Perhaps we can review Poland as an illustrative example.

In 1989 Poland suffered from four digit inflation and currently has an external debt of approximately $40 billion. As you know, Poland has embarked upon a major structural adjustment program approved by the IMF. However, reform architects have projected that the program will impose considerable hardship in 1990, including the possible loss of 400,000 jobs and a 25 percent drop in the standard of living.

The United States will be there to help Poland through this difficult period. We are providing approximately $145 million in food aid and have contributed $200 million toward the Polish Stabilization Fund. In addition, the United States helped negotiate a generous rescheduling of Poland's official debt in the Paris Club.

The Administration believes that a successful transition to a market economy in Poland demands the vigorous participation of the U.S. private sector. The President sent a mission last November led by Secretary Yeutter, and including top CEOs, which explored areas for western investment. The Polish-American Enterprise Fund was established to provide direct assistance to the private sector, including small businesses and joint ventures between the United States and Polish participants.

Just 2 days ago the President signed a Business and Economic Treaty with Poland. This is a very far-reaching treaty. It provides for national treatment for U.S. investors. U.S. investors can go to arbitration on any kind of dispute. They are protected against expropriation, and there is substantial improvement by the Poles. They have committed to permit the complete repatriation of profits by 1995. In addition, there are very far-reaching intellectual property improvements, and they have established an ombudsman to serve to help U.S. investors.

Mr. Chairman, your proposed legislation talks about shifting economic and commercial officers. We at the State Department are engaged in a major review in an effort to shift over 100 Foreign Service and foreign nationals from other areas of the world to Eastern Europe.

Senator LIEBERMAN. That is great to hear. What is the timing on that?

Mr. MCALLISTER. We hope to have that review completed within 2 months.

Senator LIEBERMAN. Great.

Mr. MCALLISTER. As Deputy Secretary Eagleburger stated in his speech before the American Chamber of Commerce, ". . . our blueprint for Central and Eastern Europe accords perhaps the highest priority to the role that the American private sector will be called upon to play in the revolutionary transformation of these economies."

To ensure that U.S. business has the opportunity to help shape Eastern Europe, the Administration: Is establishing enterprise funds in Poland and Hungary; is seeking bilateral trade and investment agreements to create the structure within which U.S. business can operate profitably; offering guarantees and credits to U.S. companies seeking to operate in Eastern and Central Europe; and is providing technical assistance which will put in place the foot soldiers of the market economy. We are reviewing our COCOM policy in an effort to facilitate U.S. business opportunities.

The Administration is committed to making significant changes in export controls in response to the dramatic developments in Eastern Europe. We believe there should be preferential treatment for Eastern Europe countries that adopt safeguard regimes, and we have begun discussions with these countries about potential safeguard regimes.

Let me turn briefly to the Soviet Union. As the President has stated, it is our interest that Perestroika be successful. There is not much the United States can do directly, but there is much we can do in providing technical cooperation and trade and investment opportunities.

The President proposed a six-part agenda at Malta to increase U.S.-Soviet economic ties. These include:

1. targeting the 1990 summit for completion of a trade agreement so that the President can grant a Jackson-Vanik waiver at that time, depending upon the Soviet Union's action to codify its emigration policy;
2. supporting observer status for the Soviet Union in the GATT after the Uruguay Round is completed;
3. expanding U.S.-Soviet technical economic cooperation. In fact, the President presented to Mr. Gorbachev a paper proposing specific economic projects coverning topics such as finance, agriculture, statistics, small business development, budgetary and tax policy;
4. exploring with the Congress the lifting of statutory restrictions on export credits and guarantees after Jackson-Vanik waiver;
5. beginning discussions of a bilateral investment treaty;
6. improving ties between the Soviet Union and the OECD.

In addition, we have a number of important economic negotiations under way, including maritime and aviation agreements. Yesterday we reached an agreement in principle on a new Long-Term Grain Agreement.

United States policy toward the Soviet Union, the initiation of negotiations of bilateral trade and investment agreements, technical training agreements on tourism, and support for GATT observership is meant to help to move the Soviet Union toward a democratic, market-oriented society. The Soviets must make the fundamental changes on their own. Our policy is designed to encourage those changes.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McAllister follows:]

TESTIMONY OF

EUGENE J. MCALLISTER

BEFORE THE

SENATE COMMITTEE ON SMALL BUSINESS

RUSSELL SENATE OFFICE BUILDING

WASHINGTON, D.C.

FRIDAY, MARCH 23, 1990

Mr. Chairman and Members of the Committee:

I am delighted to be here today to discuss with you events in Eastern Europe, the Bush Administration's response, and the implications for U.S. business, particularly small business. These are extraordinary times, and the word that best characterizes them is "opportunity": opportunity for freedom and democracy; opportunity for economic development; and opportunity for U.S. business to participate in and help shape the new Europe.

There are three major points I would like to make:

1. The Bush Administration is pursuing a positive, anticipatory policy that links political and economic freedom with the successful transformation of the East European economies. Secretary Baker characterized this policy as "new democratic differentiation" in his address in Prague on February 7.

   The essence of this policy is that we will provide assistance to these reforming governments to the extent that they continue to move in the direction of political and economic freedom and democracy. It allows us the flexibility to provide assistance where it is most needed and to withhold aid if these reforms are diverted.

   The President's Eastern European Democracy and Free Market Act of 1990 embodies this approach.

2. We tend to use the phrase "Eastern Europe" to categorize the countries and their economies. However, each of these economies is very distinct, and faces different challenges and problems.

   The Administration recognizes these differences and that is one of the reasons the President is seeking the flexibility to respond to change as it occurs and to be most effective in that response.

3. We at the State Department are convinced that U.S. business must be a critical part of our national response. U.S. business has a tremendous amount to offer the Eastern European nations: as exporters of high quality, low cost consumer and intermediate products, and as investors bringing in capital, technology, management, and above all else a stake in the success of the Eastern European nations. Creating opportunities for U.S. business is a critical element of the President's response to the changing situation in Eastern Europe.

I would like to elaborate on these points and offer some remarks on economic change and opportunities in the Soviet Union.

NEW DEMOCRATIC DIFFERENTIATION

Our policy of democratic differentiation represents a new direction in U.S. foreign policy. We will no longer expand our contact with East Eruopean governments to the extent that they differ from the Soviet Union. Instead, we will tailor our assistance to the needs of each of the East European countries as they move toward the following four objectives:

- Progress toward political pluralism, based on free and fair elections and an end to the monopoly of the communist party.
- Enhanced respect for internationally recognized human rights, including the right to emigrate, and to speak and travel freely.
- Progress toward economic reform, based on the emergence of a market-oriented economy with a substantial private sector. and
- Willingness to build a friendly relationship with the United States.

You can see this policy at work already:

- At the most basic level, we are providing for short-term emergency aid -- such as food and medicine to Poland and Romania.
- We are also taking a number of steps to promote political pluralism and to support the transition to market-oriented economies. This includes:
  - technical assistance;
  - cultural, educational, and scientific exchange programs;
  - environmental assistance;
  - funding for democratic institutions; and
  - for those countries that meet the requirements of U.S. law, normalization of bilateral trade and investment relations.
- And to those countries willing to embark wholeheartedly upon a conversion to a truly free market system, we are extending transitional economic support.

-- This support includes stabilization and structural adjustment programs. For example, the U.S. supports Czechoslovakia's membership in the IMF.

-- The United States led the way with the $1 billion stabilization fund for Poland. This stabilization fund is central to the dramatic and far-reaching reforms we are witnessing today in Poland, and the U.S. kicked it off with our contribution of $200 million.

The "Eastern European Democracy and Free Market Act of 1990"

The President's legislative proposal, the "Eastern European Democracy and Free Market Act of 1990" is designed to meet the needs of the East Europeans and, at the same time, advance our national interests, including business interests. We want flexibility to respond where our assistance is wanted, and when it is needed.

o Since enactment of the SEED Act, we have seen that events in Eastern Europe can change with unimagined speed.

-- We cannot say with certainty at what pace reforms in a given country will proceed, or even when they will occur.

-- As a matter of fact, the governments themselves do not always know in advance what problems may arise or what specific needs they may call upon us to help meet.

-- The current SEED Act does not give us the flexibility and coverage we need to respond to events in all Eastern Europe; the "Eastern European Democracy & Free Market Act of 1990" does.

This legislation includes a number of measures that will directly contribute to improving business conditions in Eastern Europe. It seeks the authority to:

-- extend the provisions of the 1989 SEED Act to other East European countries and Yugoslavia;

-- extend MFN and GSP status to those countries that meet the legislative requirements; and

-- permit OPIC to operate in the Eastern European countries.

We have asked for $300 million dollars for fiscal year 1991 and for the ability to adjust these expenditures among different programs as needed.

In addition to the legislative authority we are seeking, the Administration is going to aggressively use trade and investment agreements, the Ex-Im Bank, and our leadership role with international institutions to respond effectively and completely to the changes in Eastern Europe.

DIFFERENT NATIONS/DIFFERENT RESPONSES

Each of these countries is different, but they are all facing to some degree, three general problems: (1) macro-economic instability; (2) the need for structural adjustment, including price reform; and (3) current account imbalances and lack of hard currency. The fact that their total trade with the U.S. is less than one half of one percent of total U.S. trade is in part because of a lack of hard currency.

The move from command to market economies is not easy. During this transitional period, foreign companies will face a difficult landscape. Laws and policies will be changing. New ideas will be clashing with old habits. Credit, banking, communications, and other facilities for doing business will be well below Western standards. Nonetheless, opportunities do exist for U.S. business in Eastern Europe.

Some of the challenges facing the three most quickly emerging nations -- Poland, Hungary, and Czechoslovakia -- are:

Poland

- In 1989 Poland suffered from 4 digit inflation, and currently has an external debt of approximately $40 billion.
- As you know, however, Poland has embarked on a major structural adjustment program approved by the IMF.
    - That effort includes making the zloty internally convertible and passing new laws on banking, foreign investment, and customs, all designed to work in the free-market system.
- Reform architects have projected that the program will impose considerable hardship in 1990, including the possible loss of 400,000 jobs and 25 percent drop in the standard of living.
- The United States will be there to help Poland through this difficult period. We are providing approximately $145 million in food aid and have contributed $200 million toward the Polish stabilization fund. In addition, the U.S. helped negotiate a generous rescheduling of Poland's official debt in the Paris Club.

- The Administration believes a successful transition to a market economy in Poland demands the vigorous participation of the U.S. private sector.
  - -- The President sent a mission to Poland last November, led by Secretary Yeutter, and including top U.S. CEO's, which explored areas for Western investment, including agriculture, environmental technology, telecommunication, banking, housing, and energy.
  - -- The Polish-American enterprise fund, was established to provide direct assistance to the private sector, including small businesses and joint ventures between U.S. and Polish participants.
- Just two days ago the President signed a Business and Economic treaty with Poland.
  - -- This treaty is an important and vital step in enhancing the attractiveness of the investment and business environment in Poland.

Hungary

- Hungary is the one of the farthest along in its economic reform process. But the picture, however, is not entirely rosy.
- Hungary has a $20 billion hard currency debt and is facing the challenge of reorienting its trade and economic relations toward the West. In 1989, Hungary had $800 million surplus with Comecon, but a $1.4 billion hard currency deficit in trade with the West.
- The Hungarians are committed to economic reforms and are working to improve the investment climate in their country. The reform program includes:
  - -- Tax banking, investment and foreign trade reform.
  - -- Privatization of state enterprises and improvement of intellectual property laws are in progress.
  - -- Reductions in industrial subsidies, wage and price reform, abolition of unproductive monopolies, launching of a small equity market and more rational allocation of resources.
  - -- Hungary and the IMF have reached agreement on a stand-by arrangement.

- We hope to begin negotiating a Business and Economic Treaty with the Hungarians as soon after the March 25 elections as possible.
- U.S. companies are already investing in Hungary without the assurances of such an agreement because of their faith in the reform process now underway.
    - U.S. investment in Hungary has increased five fold over the past year.
    - General Electric's deal with Tungsram is just one example of the types of opportunities that exist.

Czechoslovakia

- Czechoslovakia's economy is one of the more advanced in the region. It has a low external debt, estimated at $7.8 billion in 1989 -- less than 5 percent of its GNP.
- But it also has its share of challenges:
    - The capital stock is old -- one third of it is from before World War II;
    - Domestic investment has been skewed toward heavy industry; and
    - foods and fuel are heavily subsidized.
- The Government of Czechoslovakia is also pursuing a reform program, albeit not as radical or as rapid as that of neighboring Poland. Instead, they plan to focus first on demonopolizing the economy and controlling inflation.
- The Administration is in the process of negotiating a trade agreement and [illegible] investment treaty with Czechoslovakia in an effort to secure a better environment for our businesses.

THE IMPORTANCE OF U.S. BUSINESS

As Deputy Secretary Eagleburger stated in his speech before the American Chamber of Commerce's International Forum on February 16:

> "...our blueprint for central and Eastern Europe accords perhaps the highest priority to the role that the American private sector will be called upon to play in the revolutionary transformation of these economies."

The U.S. government is meeting the challenge in Eastern Europe, but the transformation and recovery of the East European economies will ultimately depend on the development of the private sector. U.S. business can bring capital, management, and technology and above all else be a partner who has a stake in the success of those countries.

To ensure that U.S. business has the opportunities to help shape Eastern Europe, the Administration:

-- is establishing enterprise funds in Poland and Hungary to serve as catalysts for the private sector;

-- is seeking bilateral trade and investment agreements to create the structure within which U.S. business can operate profitably;

-- is offering guarantees and credits to U.S. companies seeking to operate in Eastern and Central Europe;

-- is providing the technical assistance which will put in place the foot soldiers of the market economy; and

-- is reviewing its COCOM policy in an effort to facilitate U.S. business opportunities.

Let me elaborate on the last point.

COCOM

o The Administration is committed to making significant changes in export controls in response to the dramatic developments in Eastern Europe and the Soviet Union.

  -- We are guided by several basic principles: 1) support for the reform process; 2) strengthened protection of truly strategic goods and technologies; 3) more rapid modernization of the control lists; and 4) decontrol of off-the-shelf commodities readily available to the general public.

  -- We believe there should be preferential treatment for Eastern European countries that adopt safequard regimes.

o We have already agreed to reduce case processing time in COCOM by one third for all proscribed countries and have adopted an ambitious work plan to accelerate relaxation of the controls in three key areas: computers, machine tools, and telecommunications.

- We and our COCOM partners also agreed to consider whether there should be more favorable treatment for proscribed countries that adopt safeguards against diversion of controlled technology.
  - Safeguards are not ironclad guarantees. However, the Administration believes that, together with the fundamental reforms that have taken place in Eastern Europe, they would give us the necessary margin of comfort and leverage to justify the export of higher levels of strategic technology to these countries.
  - Several Eastern European countries have offered to adopt safeguard regimes in exchange for greater access to U.S. technology.
- The President has ordered a comprehensive strategic review of our COCOM policy. The findings from this review will form the basis of comprehensive U.S. proposals for the modernization of COCOM. These proposals will be ready prior to the June High Level Meeting.
  - We expect that the review will provide a coherent strategic rationale to support significant reductions in current controls.

International Efforts

- At the G-7 Summit last July the President proposed that the industrialized countries coordinate their assistance to Eastern Europe. That has come to be known as the G-24 process.
  - As of February, total G-24 assistance had exceeded $13 billion, including lines of credit and export guarantees.
  - Major contributors include the U.S., FRG, Japan, France, and the EC.
- We are pleased that the industrialized nations are working together to further the movement toward political liberty and economic freedom in Eastern Europe.
  - We are insistent, however, that all trade and investment agreements are done on a MFN basis and that all aid be untied.

-- We further believe that untied aid credits are more responsive to the recipient countries' development needs by allowing them to decide which supplier best meets their needs, rather than requiring them to buy from the country offering cheaper financing.

- The OECD has adopted the U.S. proposal to establish a Center for Cooperation with the European Economies in Transition.

- The U.S. is also engaged in discussions to create a European Bank for Reconstruction and Development.

The Soviet Union

Let me now turn briefly to the Soviet Union. As the President has said it is in our interest that Perestroika be successful. There is not much the U.S. can do directly, but there is much we can do in providing technical cooperation and trade and investment opportunities. The President proposed at Malta to increase U.S. - Soviet economic ties:

1. Targetting the 1990 summit for completion of a trade agreement granting most favored nation status to the Soviet Union so that the President can grant a Jackson-Vanik waiver at that time. To reach that goal, the President proposed beginning negotiations on a trade agreement and urged the Supreme Soviet to complete action on its emigration legislation early 1990.

2. Supporting observer status for the Soviet Union in GATT (General Agreement on Tariffs and Trade) after the Uruguay Round is completed next year. The President urged the Soviet Union to use the intervening time to move toward market prices at the wholesale level so its economy will become more compatible with the GATT system.

3. Expanding U.S.-Soviet technical economic cooperation. The President presented a paper proposing specific economic projects covering topics such as finance, agriculture, statistics, small business development, budgetary and tax policy, a stock exchange, and antimonopoly policy.

4. Exploring with Congress the lifting of statutory restrictions on export credits and guarantees after a Jackson-Vanik waiver.

5. Beginning discussions of a bilateral investment treaty that would provide protections for American business people who want to invest in the Soviet Union.

6. Improving ties between the Soviets and the OECD (Organization for Economic Cooperation and Development), and East-West economic cooperation through the economic basket of the CSCE (Conference on Security and Cooperation in Europe.

- In addition, we have a number of important economic negotiations underway, including maritime and aviation agreements. Yesterday we reached an agreement in principle on a new Long Term Grain Agreement.

- We already have a number of specific technical economic cooperation projects underway:

  - As you know, a Soviet small business delegation recently visited the United States to study the important role small firms play in the American economy.

    - The small business delegation expressed its desire to learn more about state and federal initiatives in the United States that encourage small businesses.

    - They were especially interested in promoting joint ventures in the areas of forestry, food processing, and construction.

    - We should support these efforts to learn more about private enterprise and the role of small businesses in a market economy.

  - Another U.S. initiative involved a Soviet Stock Exchange Delegation, which recently took a tour of the New York Stock Exchange and spent ten days learning about securities and capital markets.

- At the 11th Joint Commercial Commission last November, we and the Soviets agreed to establish a working group to develop tourism.

  - At the same meeting, it was agreed that we would expand cooperation in the consumer sector. We have invited a Soviet delegation to come here to see how our consumer distribution system works and to meet with American producers of consumer goods.

- The presence of U.S. businesses with their entrepreneurial spirit can only help to move the Soviet Union toward a market economy.

- U.S. policy toward the Soviet Union -- the initiation of negotiation of bilateral trade and investment agreements, technical training and support, agreements on tourism, and U.S. support for Soviet observership at the GATT after the Uruguay Round -- is meant to help it move toward a democratic, market-oriented society. The Soviets must make these fundamental changes on their own. Our policy is designed to encourage these changes.

Senator **Lieberman**. Thank you, Mr. McAllister.

Now we welcome the Assistant United States Trade Representative, Peter Allgeier.

STATEMENT OF PETER ALLGEIER, ASSISTANT U.S. TRADE REPRESENTATIVE FOR EUROPE AND THE MEDITERRANEAN

Mr. **Allgeier**. Thank you very much, Mr. Chairman, for the opportunity to testify before the Small Business Committee. I think it is very important to foster the involvement by small- and medium-size U.S. businesses in the events that are occurring in Eastern Europe and the Soviet Union, and I would cite two reasons.

First of all is the contribution that these businesses can make to the process in Eastern Europe. The people of these countries of repressed entrepreneurship really need the example of and direct contact with small-scale entrepreneurs from the West. An indigenous free enterprise system is more likely to grow in the small- and medium-size enterprises in Eastern Europe than from the large state enterprises that exist there now.

The second reason for fostering the involvement of U.S. small- and medium-size businesses in Eastern Europe is for the benefit that is possible for our own businesses through new export opportunities, through licensing arrangements, and in some cases even through new joint ventures.

I think that we should not assume that the only enterprises that can benefit from the changes in Eastern Europe are large multinational enterprises.

The Administration's trade and investment policy approach to Eastern Europe and the Soviet Union, broadly speaking, has two objectives. First is to promote U.S. commercial interests. By that, I mean obtaining market access, putting in place provisions for business facilitation, getting protection for U.S. investors, and getting protection for our intellectual property rights.

The second objective is to promote the economic reform in Eastern Europe and the Soviet Union. By that, I mean promoting the privatization of the means of production promoting decentralized economic decisionmaking, promoting reliance on price mechanisms to allocate resources and to determine the patterns of production and trade, and reliance on market forces to determine those prices, including the very critical prices of exchange rates, interest rates, wages, and retail and wholesale prices.

The first steps that we are taking in trade and investment policy, which is only a part of the Administration's overall response to Eastern Europe, is to negotiate trade and investment agreements. I think there are four reasons that these agreements are so important.

First, they provide a greater degree of predictability and certainty for U.S. entrepreneurs about the conditions that they will face in this unfamiliar economic terrain of Eastern Europe. I think that is especially important for small- and medium-size businesses who do not have significant in-house resources to determine what the legal situation is or to ensure that they are operating in a favorable legal environment overseas.

The second reason that these agreements are important is that they push the Eastern European and Soviet governments to stretch beyond their normal inclinations in terms of instituting the kinds of business flexibility and commercial regulations that are the norm in the West.

Third, these agreements are important to ensure that U.S. enterprises are not discriminated against vis-a-vis their competition from Western Europe, Canada or Asia. We want to ensure that our people are competing on at least as favorable a basis as the rest of the world.

Fourth, such agreements can set the stage for integrating these economies into the multilateral trade and investment system of the West, notably the GATT and the OECD, and on terms that will strengthen those institutions rather than dilute them.

I would like to spend just a few minutes to talk about the agreements that we are seeking. The different situations of the countries with respect to most favored nation treatment and with respect to coverage under the Jackson-Vanik amendment require different forms of agreements, but it is our intention to achieve essentially the same protections and flexibilities at the end of the day in each country.

Where we currently have no MFN relationship and in countries that are covered by Jackson-Vanik, we would seek two agreements once we have the approval from the State Department on foreign policy grounds to go ahead.

The first agreement would be a Title IV trade agreement, under the Trade Act of 1974. This is required in order to give these countries Most Favored Nation (MFN) treatment. That sort of agreement would have an exchange of MFN treatment for tariff and nontariff barriers. It would also have protection for intellectual property, market disruption provisions, trade promotion, and business facilitation provisions.

In parallel, we would seek a separate agreement on investment, a bilateral investment treaty. These treaties typically provide for the right of establishment, the better of national treatment or most favored nation in the operation of an investment, protections against expropriation, procedures for prompt compensation, dispute settlement mechanisms, and also provisions dealing with the transfer of funds; that is, profits, either hard currency profits or profits in local currency that have to be converted before repatriation.

Those are the two types of agreements that we are contemplating with those countries. That framework would apply to Czechoslovakia and the Soviet Union. In both cases we have started negotiations. Bulgaria falls in the same legal situation. We have not started negotiations with them pending foreign policy guidance from the State Department. The German Democratic Republic, which is to say East Germany, legally is in the same situation, but given the expectation of reunification we are not seeking at this time to do a separate agreement with them.

Where we currently have Most Favored Nation relations—that is, with Poland, Hungary and Yugoslavia—we would seek only one agreement, a business and economic treaty along the lines of the one that we just negotiated and which the President signed with Poland. It has essentially the same elements as the trade and investment agreements with Title IV countries except that it does not have the trade elements because there is no need to exchange MFN at this point.

I mentioned that we finished the agreement with Poland. We will explore a similar agreement with Hungary after their elections on March 25.

Romania is a separate case because they have renounced MFN, and we would have to determine how to proceed with them.

No decision has been made yet on how to proceed with Yugoslavia, but we certainly do not want to leave them behind as their neighbors establish improved relations with the West.

Beyond the negotiation of bilateral agreements, we are at some point presumably going to have to normalize our relationships in GATT. I will not discuss that now. It is discussed in the written testimony and in the matrix which is attached to my testimony.

I would simply like to close by saying that in all aspects of our negotiations and in the development of our negotiating positions we have benefited enormously from our consultations not only with Congress but also with the private sector including many small-and medium-sized businesses. They often provide us, frankly, with the most detailed information about the problems that one encounters in these countries, and so that has been very, very helpful to us in putting together our positions.

I would like to assure the Committee that we will continue to be very responsive to the small- and medium-sized businesses of the United States.

[The prepared statement of Mr. Allgeier follows:]

TESTIMONY OF
PETER ALLGEIER
ASSISTANT UNITED STATES FOR TRADE REPRESENTATIVE
For
EUROPE AND THE MEDITERRANEAN

Before the
SMALL BUSINESS COMMITTEE
UNITED STATES SENATE

MARCH 23, 1990

It is a pleasure for me to appear before the Small Business Committee this morning. I look forward to discussing with you recent economic reforms in the Soviet Union and the countries of Eastern Europe and the opportunities presented thereby for U.S. trade and commerce, especially for small and medium-sized American enterprises.

Overall, the Bush Administration is attempting to foster the operation of market forces in the reforming economies of Eastern Europe through solid trade and investment agreements, along with assistance targeted to the private sector. This is the proven recipe for creating prosperity and for increasing economic opportunities for the United States in these developing and potentially lucrative markets.

I would like to use my time today to give you a snapshot of our trade and investment negotiations and agreements with each country, along with a roadmap of where the Office of the United States Trade Representative sees the trade and economic relationships going.

ECONOMIC REFORMS AND THE U.S. RESPONSE

Political and economic reform in Eastern Europe is transforming one of the most stagnant areas of the world into one of exciting possibilities. Clearly, it is in the American interest to promote such change, both for strategic and for commercial reasons. If, for instance, all Eastern European countries had a per capita income equivalent to the average of the European Community (not an unfair comparison given the range of development among EC member states), those combined economies would be half a trillion dollars larger. If the Soviet Union had the same per capita GNP, its output would swell by over a trillion dollars. No one believes such growth will occur overnight, but clearly these economies have enormous potential and effective demand for imported goods and services.

The question in front of everyone -- West Europeans, Asians, North Americans -- is how to help centrally-planned, communist-run economies transform into decentralized, market-based economies. Our approach has taken three tacks: targeted assistance, strong trade and investment agreements, and conditioned support for inclusion in global trade and economic bodies such as the GATT or IMF. We believe that this cohesive and organic approach, coordinated closely with our industrialized partners, can both entice and guide Eastern European governments along the road of market-based reform and development.

SPECIFIC RESPONSES: ASSISTANCE

Working together with the Congress, the Administration responded to the first reform initiatives by launching a wide-ranging assistance program for Poland and Hungary, which we have implemented pursuant to the "Support for East European Democracy" (SEED) Act of 1989 and through our cooperation with the Group of Twenty-Four (G-24) countries. This year the Administration has continued to promote the reform efforts by proposing legislation which will authorize assistance to all emerging democracies in Eastern Europe, including Yugoslavia, which pursue market-oriented reforms. My colleagues from the Departments of State and Commerce will describe in greater detail some of these programs and the resources available through them to American firms and entrepreneurs. I will simply say that we have been very impressed with the East European Business Information Center, mandated under the SEED Act and coordinated by the Department of Commerce, and its responsiveness to private sector inquiries and needs, including the thousands of inquiries from small and medium-sized companies that do not have the resources to hire expensive consultants.

TRADE AND INVESTMENT AGREEMENTS

Our trade and investment policy toward Eastern Europe complements our financial aid and technical assistance packages. The trade and investment aspects of our policy are being coordinated by the interagency Trade Policy Review Group (TPRG), chaired by USTR, within the context of our broader foreign policy objectives.

Quite simply, we seek a normalization of economic relations with Eastern European countries and the Soviet Union to the extent that they are taking steps toward political pluralism (based on progress toward free and fair elections and an end to the monopoly of the communist party), respect for human rights (including the right and opportunity of citizens to emigrate), a willingness to build a friendly relationship with the United States, and movement toward market-oriented economies.

The degree and the speed of economic reform -- privatization, decentralization of economic decision-making, reliance on price mechanisms -- in each Eastern European country will be the determining factor in achieving domestic growth and prosperity, as well as competitiveness in world markets. The speed of reform also determines where we are putting our negotiating resources. Our bilateral trade and investment agreements can help shape the business environment and encourage greater inward investment and two-way trade in goods and services between our countries. But U.S. trade agreements cannot substitute for domestic reform and the hard choices that must be made.

Nonetheless, good agreements can help build business and investor confidence, and thereby promote trade and development. This is especially important, I believe, for smaller American companies, whose experiences with exporting at all may be minimal, and for whom exporting to Eastern Europe may be a real challenge. The governments in each Eastern European country will continue over the near term to play a central role in the market, but our agreements ought to ensure that American firms can operate with maximum flexibility in their day-to-day operations and be confident of receiving fair treatment in all aspects of their commercial activities.

The particular forms of agreements sought by the U.S. with each Eastern European country depend upon whether the country in question already has most-favored-nation (MFN) status and whether it is covered by the Jackson-Vanik amendment. Before I describe our talks with each country, let me summarize the three types of agreements being sought, depending on the different relationship with each country.

Under **Title IV of the Trade Act** of 1974 ("Jackson-Vanik"), **commercial agreements** are required before we can grant MFN status to Czechoslovakia, East Germany, and Bulgaria, as well as the Soviet Union. These Title IV trade agreements will provide reciprocal assurances and access to markets for enterprises, traders and entrepreneurs. Title IV contemplates certain objectives, such as effective protection for intellectual property, removal of barriers to trade, business facilitation elements such as freedom to establish commercial representation offices, fair pricing and access to internal distribution networks, and so on. Title IV trade agreements also ensure effective procedures for addressing market disruption resulting from import surges from these reforming command economies. These trade agreements have an initial duration of three years, with the option to continue them for additional periods of three years at a time. They do not permit us to provide permanent (i.e. unconditional) MFN treatment because unsatisfactory performance with respect to emigration policy would require us to withdraw MFN treatment.

For the American exporter, our trade agreements should provide predictability and avenues of redress in cases of unfair treatment. Of particular interest for small American companies, we seek through these agreements the right of companies to hire local representatives or distributors for their goods and services, which is often more cost-effective than establishing an independent presence in these countries. Stronger intellectual property protection should also reassure our companies that their designs and inventions will not be stolen or misused.

With most Title IV trade agreement countries we will also seek **bilateral investment treaties** (and perhaps with Yugoslavia as well). Our objectives in these treaties are: the right to establish an investment and thereafter to be treated on a basis no less favorable than the better of MFN or national treatment; binding dispute settlement procedures including referral to third party arbitration at the investor's decision; international law standards for expropriation and compensation; and unrestricted transfers of funds associated with investments. In the case of centrally planned economies in transition, we would also require opportunities for competition for U.S. investors equivalent to state-owned enterprises.

Where we already have valid trade agreements and/or MFN in place -- i.e., with Poland through the GATT and bilaterally with Hungary -- we are looking at forging stronger agreements that incorporate extra business facilitation items and intellectual property protection in addition to the investment protections listed above. We call these agreements **"Business and Economic Treaties."** We may also wish to revise our 1975 Title IV trade agreement with Romania along these lines as we seek to restore MFN treatment to that country (lost in 1988 when the Ceaucescu regime unilaterally renounced MFN after persistent criticism from the U.S. of violations of that government's human rights).

COUNTRY-SPECIFIC UPDATES

With that general backdrop, let me describe the status of our trade and investment work with each of the seven Eastern European countries and the Soviet Union. I have also attached to my written testimony a matrix prepared by USTR staff giving an overview of each country's status on MFN, GSP and GATT.

Poland

Poland already benefits from MFN and Generalized System of Preferences (GSP) treatment. That means that Polish goods already receive MFN tariff treatment and, in the product categories of GSP in which they export, their goods can enter the United States duty-free. In addition, we are sending a GSP team to Poland to explain to Polish enterprises how to benefit from GSP, and the procedures to petition for an expansion of GSP product coverage.

Because our MFN relationship with Poland predated the 1974 Trade Act, Poland has not been subject to Jackson-Vanik, and we are not required to conclude a trade agreement with the Polish Government. Nonetheless, both sides realized the utility in having an agreement in place which would provide assurances and protections to traders and investors, thereby building confidence in the Polish business environment.

I am pleased to report that President Bush and Prime Minister Mazowiecki signed a comprehensive Business and Economic

Treaty this Wednesday. This treaty, when ratified and put into effect, will offer U.S. investors treatment equivalent to the treatment extended to Polish or foreign firms, whichever is better, in addition to assurances that their investment proposals will receive speedy consideration by Polish authorities. Our investors and entrepreneurs will be assured that Polish laws and regulations affecting trade will be readily available, and that they will be treated no less favorably than any other country's firms, including the ability to sell at the wholesale and retail level. American enterprises will be allowed to immediately repatriate export earnings and proceeds from liquidations, and the Polish Government has committed to progressively eliminate all restrictions on zloty profits by 1995. Our investors will have the right of third party arbitration in investment disputes, and there will be significantly stronger intellectual property protection in Poland, both for copyrights and patents.

Hungary

We have explored very informally with the Hungarian government negotiation of a similar agreement since Hungary also already enjoys MFN status. Unlike Poland, Hungary is subject to Jackson-Vanik. Our Title IV trade agreement and reciprocal MFN dates from 1978 and provides a solid basis for trading with Hungary. A decision to move forward with negotiations of a new or complementary agreement will await the Hungarian elections (March 25). At that point the Administration and the Government of Hungary can review the merits and needs of a stronger agreement between our countries.

Czechoslovakia

Subsequent to the President's announcement of a one-year waiver of the Jackson-Vanik amendment during President Havel's recent visit to Washington, we agreed to initiate Title IV trade agreement negotiations with Czechoslovakia. We have held one round of very productive talks in Prague at the beginning of March and have scheduled a second round for the first week of April in Washington. The Czechoslovak government has made significant progress in reforming, or in proposing reforms for, its economy. Its negotiators have told us that our trade agreement proposals make sense and that they believe we can reach closure on a trade agreement this spring. The fact that Czechoslovakia is a GATT member should simplify the negotiating process.

The investment treaty talks, which commenced at the same time, are likely to move more slowly. The financial situation in Czechoslovakia is difficult, and there are still certain elements in the Czechoslovak government who resist extending full national treatment to foreign investors. The U.S. side is willing to complete the trade agreement before the investment treaty because we understand the symbolic importance of MFN, but, frankly, if the Czechoslovaks want to grow through Western investment, technology and skills, then they should be eager to conclude an investment agreement.

Romania

In 1988 the Ceaucescu regime unilaterally renounced the terms under which it was accorded MFN status (i.e. the Jackson-Vanik requirements). Such treatment had been accorded reciprocally following the 1975 Title IV trade agreement between our countries. That agreement is still in effect in terms of business facilitation, dispute settlement, intellectual property protection and so on -- we simply have suspended MFN on Romanian goods and vice-versa.

The question then is: assuming the Government of Romania can qualify for a waiver of Jackson-Vanik (which the State Department is still considering), how should we proceed to strengthen the bilateral trade relationship? We could simply reestablish MFN on goods -- that is, mutually decide to reestablish Article 1(2) treatment under the 1975 Trade Agreement. On the other hand, since the trade agreement is due for renewal in August of this year, it might make sense to seek stronger trade and investment agreements, for instance through a Business and Economic Treaty.

Bulgaria

Bulgarian trade officials have met with us, and we have described for them the sorts of agreements we are seeking with Czechoslovakia. Like Czechoslovakia, Bulgaria is subject to Jackson-Vanik -- we therefore would require a Title IV trade agreement for MFN and might seek a separate investment agreement. However, the State Department is still reviewing the emigration situation in Bulgaria to see if that country merits a waiver of Jackson-Vanik. If and when the conditions are met, the U.S. Government would be prepared to negotiate agreements leading to better access for our companies and investors, including the reestablishment of MFN tariff treatment.

East Germany

The Administration has not held formal trade or investment talks with the German Democratic Republic. That state is also subject to Jackson-Vanik, and its goods do not receive MFN treatment. We, along with the rest of the world, are waiting to see what decision the German people make in terms of reunification. From USTR's perspective, if economic and political reunification were to occur quickly, we would not seek a trade agreement. On the other hand, if reunification appeared likely to take some time, and in the meantime East German goods were still subject to non-MFN treatment, then it might make sense to negotiate trade and investment agreements. For the immediate future we will continue to monitor the situation.

Yugoslavia

Among Eastern Europe and Communist-run countries, Yugoslavia has been a case apart for the last forty years. Given its policy independence from Moscow, its more market-based economy, and our consistent trade relationship with Belgrade (we have reciprocal MFN since 1948), there has been no pressing need to seek additional trade agreements. After all, Yugoslavia has been a member of GATT since 1966 and is an observer at the Paris-based Organization for Economic Cooperation and Development (OECD). It also has associate status in the European Community.

Nevertheless, we may consider the possibility of crafting a stronger bilateral investment relationship, either through a BIT or through a Business and Economic Treaty. As the rest of Eastern Europe thaws, the Government of Yugoslavia wants to retain its attractiveness to companies wishing to establish ventures in Eastern Europe. However, no decision to proceed with an investment agreement has been taken yet.

The Soviet Union

Let me turn briefly to the Soviet Union, where we also have the negotiation of trade and investment agreements underway. Initial trade agreement talks were held in Washington, and a second round in London. Deputy USTR Julius Katz today is wrapping up the third round in Vienna. As with Czechoslovakia, we are seeking two agreements. The trade agreement leading to reciprocal MFN will be based on the Title IV objectives. As you know, Presidents Bush and Gorbachev instructed the negotiators to complete an agreement in time for signature at the June Summit, and we are working hard to complete a sound agreement by that deadline.

Negotiations of an investment agreement are moving more slowly and do not have a deadline attached. We held our first round of talks March 12-14. Quite frankly, the Soviet economic reforms are so inchoate and, in terms of foreign investment, are so different from Western norms, that we will find it difficult to get a meaningful investment agreement in a hurry, in my opinion.

GATT AND EASTERN EUROPE

Complete "normalization" of our trade relations in the multilateral trading framework of GATT cannot occur as long as U.S. trade law (i.e., the Jackson-Vanik amendment) conditions the grant of MFN on satisfaction of domestic statutory requirements. Article I of the GATT requires unconditional application of MFN treatment to other GATT signatories, and we cannot promise unconditional MFN given Jackson-Vanik. This applies in particular to GATT members, i.e., Hungary, Czechoslovakia and Romania. This constraint on normalization does not exist for Poland and Yugoslavia, both of which are GATT members and neither of which is subject to Jackson-Vanik.

We have taken different courses of action with each to take account of the country's ability to adhere to GATT standards and to take account of Jackson-Vanik. With Hungary and Romania, the U.S. invoked Article XXXV (non-application) of the GATT at the time of their accession. The matter is more complex with Czechoslovakia, which is a GATT founding member in good standing since 1948, but with whom we suspended GATT relations -- with the approval of other GATT contracting parties -- in 1951. The issues are more for the future with Bulgaria and the Soviet Union, neither of which is a GATT member (Bulgaria has been an observer since 1967 and is now applying for membership; the USSR has asked for observer status, which we have said should be delayed until the conclusion of the Uruguay Round).

As the democratization and economic reform processes in Eastern European countries evolve, pressures for full normalization, stemming both from their governments and from the U.S. private sector, will mount. From a trade perspective, integration of their economies into the world trading system, based on strict compliance with the requirements of the system -- adoption of price based mechanisms being the key -- is in the United States' economic interest.

NEXT STEPS

I have tried in each of the country descriptions and in my review of GATT relations to detail some of the next steps we expect in our process of improving bilateral trade and investment ties with Eastern Europe and the USSR. Throughout the process, we have been guided by consultations with the Congress and advice from the private sector, notably the Investment Policy Advisory Committee (INPAC), and through public comment solicited through notice in the Federal Register. In addition, we have had the benefit of innumerable calls and letters from American entrepreneurs, many of whom run small or medium-sized firms, who have provided us with detailed descriptions of problems that they have encountered or expect to encounter in doing business in or with Eastern Europe and the Soviet Union. I want to assure this committee that we take very seriously our obligation to be responsive to these small and medium-sized enterprises in our negotiation of trade and investment agreements.

EASTERN EUROPE

STATUS UNDER GATT

Country	Member/ Date of Accession	Condition of Membership	U.S. Conditions	Changes in Current GATT Arrangements
Bulgaria	observer status since 1967			applied for membership in 1986; working party established but not yet activated
Czechoslovakia	founding member January 1948	standard protocol	mutual suspension of GATT relations in 1951; subject to CP Declaration	GOC requested mutual withdrawal of suspension
GDR	not member			no plans known
Hungary	September 1973	NME conditions in protocol	Article 35 (non-application under GATT, but applied bilaterally conditionally)	requested U.S. to withdraw invocation of Article 35
Poland	October 1967	NME conditions in protocol		requested renegotiation of protocol
Romania	November 1971	NME conditions in protocol	Article 35 (non-application under GATT, but applied bilaterally conditionally)	no request for change of status
USSR	not member			requested observer status
Yugoslavia	August 1966	standard protocol		no request for change status

Prepared by USTR
March 22, 1990

EASTERN EUROPE

MFN STATUS

Country	*Benefits from MFN Treatment	Subject to Title IV/ Jackson-Vanik(J-V)	Status of J-V Waiver on Emigration	Status of Title IV Trade Agreement	Status of Investment/ Other Agreements
Bulgaria	no	yes	not yet granted		
Czech-oslovakia	no	yes	President announced 1 year waiver Feb. 20	first round negotiations March 5	first round of BIT negotiations March 6
GDR	no	yes	not yet granted		
Hungary	yes (since 1978)	yes	annual waivers from 1978 to 1988; certified Nov. 1988*	Trade Agreement signed in 1978; in effect	
Poland	yes since 1962 (suspended from 1982 to 1987 based on violation of GATT protocol)	no	N/A	N/A	Business and Economic Treaty signed March 21, 1990
Romania	MFN granted in 1975; terminated July 1988 when GOR renounced MFN; not reinstated	yes	not yet granted	Trade Agreement since 1975; still in effect except for MFN; Romania has requested reactivation; awaiting J-V decision	
USSR	no	yes	not yet granted	under negotiation	under negotiation
Yugoslavia	yes since 1948	no	N/A	N/A	BIT or Business and Economic Agreement will be reviewed by TPSC

* Under Jackson-Vanik emigration criteria, the President may: (a) waive, upon annual review, the Jackson-Vanik requirements for a country if he determines that such waiver will promote free emigration and he has received assurances that its emigration practices will lead substantially to free emigration; or (b) certify that a country's emigration practices meet the standards under the Jackson-Vanik amendment and report to the Congress every six months that the country continues to be in compliance. In either case, MFN remains conditional.

** Business and Economic Agreements include model BIT protections, as well as business facilitation and IPR provisions. They are appropriate for countries with which we have old (narrow) trade agreements, e.g. Romania and Hungary, and countries with which we have no, and do not plan to negotiate any, trade agreements, e.g. Poland and Yugoslavia.

Prepared by USTR March 22, 1990

EASTERN EUROPE

STATUS OF GSP TREATMENT

Country	Date Designated GSP Beneficiary	Legislative Eligibility	*Administratives Eligibility
Bulgaria	N/A	** no legislative prohibition	TPSC will monitor and review eligibility
Czechoslovakia	N/A	explicitly prohibited under U.S. GSP law	Administration proposed removal from prohibition list; TPSC will monitor and review eligibility
GDR	N/A	explicitly prohibited under U.S. GSP law	Administration proposed removal from prohibition list; TPSC will monitor and review eligibility
Hungary	November 3, 1989	** no legislative prohibition	yes
Poland	January 9, 1990	removed from prohibited list, Nov. 1989	yes
Romania	1976 = original GSP beneficiary; terminated March 1987 because of treatment of workers' rights; not reinstated	** no legislative prohibition	not yet reviewed by TPSC; must await MFN reinstatement
USSR	N/A	explicitly prohibited	no request to change
Yugoslavia	1976 = original beneficiary	** no legislative prohibition	yes

* Criteria for President's granting of GSP (once legislative ban removed). Among these requirements are:
- -- IMF membership if communist country
- -- GATT membership
- -- Must meet International Standards for Workers' Rights
- -- Must have MFN treatment
- -- Must meet GNP per capita standards (Per capita GNP current ceiling of $10,400 for 1989)
- -- Should provide adequate and effective intellectual property rights

** The Congress never placed Bulgaria, Romania and Yugoslavia on the prohibition list. Hungary was removed from prohibited list in 1984, and did not receive GSP until 1989.

Prepared by USTR March 22, 1990

Senator LIEBERMAN. Thank you, Mr. Allgeier.

Our final witness on this panel is the Assistant Secretary of Commerce for International Economic Policy, Thomas Duesterberg. Welcome.

STATEMENT OF HON. THOMAS J. DUESTERBERG, ASSISTANT SECRETARY OF COMMERCE FOR INTERNATIONAL ECONOMIC POLICY, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Mr. DUESTERBERG. Thank you, Mr. Chairman and Members of the committee. It is a pleasure for me to be here today to discuss this topic which is of such vital interest to all of us. My colleagues have generally covered the foreign policy and economic policy considerations. I will try to focus my remarks here on what we are doing to try to promote American commercial interests in this part of the world.

There are basically two fundamental reasons why we should be as interested as we are in Eastern Europe and the Soviet Union. First, as Mr. McAllister pointed out, we think that economic stability and economic reform are the key building blocks for political stability in this region. Of equal importance to us is the fact that there are large untapped markets in Eastern Europe and the Soviet Union that we need to focus on before we are left behind.

We have to admit that some of the countries in the region are more committed to reform than others and that economic reform is usually more slow than political reform. We have to be realistic about the obstacles faced by these countries and the size and composition of the markets awaiting American business in Eastern Europe.

In 1989 the combined total of U.S. exports to the seven nations of Eastern Europe was just over $1 billion, roughly the size of our total exports to Norway. Our market share of hard currency exports to Eastern Europe was 5 percent compared to Western Europe's 90 percent.

Eastern European countries must still create many elements of the basic infrastructure needed for a free market. They lack the necessary legal and accounting structure to support even the most basic market economy. Telecommunication, transportation, and distribution systems are inadequate in these countries. Wholesale markets in many instances simply do not exist.

This does not mean that there are not substantial opportunities for U.S. trade and investment in the region. Many of the early opportunities will be in helping these nations create the basic infrastructure that they require.

While the dominance of Western Europe in the Eastern European market continues an historical trend, we feel there are very real opportunities for U.S. firms to increase exports to and market share in this region. Indeed, in all of our visits with Eastern Europe there is a very real desire partly based upon historical ties between our countries to have American investment and American trade as a counterbalance, if you will, to trade with other parts of the world.

Early participation by American firms will position them well for the rapid growth the liberalizing economies of Eastern Europe should enjoy in the future. Also, it can provide a point of entry into the potentially huge Soviet market as a base for selling into Western Europe.

Strong American investment and trade in Eastern Europe also benefits our other interests by contributing to the stabilizing influence American presence brings to Europe.

Let me turn briefly to what the Department of Commerce in conjunction with many of our sister agencies is doing to build a commercial relationship with the nations of Eastern Europe. Our approach is three-fold.

First, is to foster the creation of the infrastructure in Eastern Europe necessary to develop and sustain a market economy.

Second, is to build an awareness in the U.S. business community of the changes in opportunities in Eastern Europe.

Third, is to assist these companies in building business in these markets.

My two colleagues have outlined the policy response most importantly recently in the negotiation of business and economic agreement and investment protection agreements. We feel that these are fundamental building blocks to create the climate conducive to American trade and investment.

Secretary Mosbacher has also visited several of these countries, Poland, Hungary, and Czechoslovakia and has emphasized the importance of moving as rapidly as possible toward economic liberalization.

Let me focus on the second area of increasing U.S. business awareness of opportunities in Eastern Europe. Our Department has been given the responsibility by Deputy Secretary Eagleburger for private sector outreach for Eastern Europe. To this end we have recently opened the East European Business and Information Center which we call EEBIC. This is the center called for in the Support for East European Democracy, or SEED, act of 1989.

Since its opening on January 23 of this year we have taken over 7,000 phone calls from American companies, the vast majority of them being small-and medium-sized firms. EEBIC serves as the Federal Government's central clearinghouse for information on: First, business needs and opportunities in Eastern Europe; and second, voluntary assistance to East European countries.

Branches of this center are being integrated with our U.S. and Foreign Commercial Service operations in Eastern Europe. EEBIC is developing along with the Small Business Administration and other agencies a data base of companies that have requested information. This list will be used to help further expand and target our trade promotion activities. A periodical news bulletin on Eastern Europe is currently under development.

Our third and most priority is the Department's efforts to expand U.S. business presence and involvement in this new market. Besides coping with inadequate infrastructure, U.S. companies must confront the lack of the most basic information. There are no business registers, yellow pages or Dun & Bradstreet listings. The Department of Commerce is planning a major increase in trade promotion and business assistance effort in Eastern Europe to address this very problem.

We are developing a wide-ranging series of "Doing Business in Eastern Europe" seminars to be held by our district offices. New publications are under way, and the U.S. and Foreign Commercial Service is expanding the number and variety of trade promotion programs held in the East European nations and tailoring them to specific markets.

The United States and FSC has assigned senior commercial officers already to Prague and Berlin and is doubling the foreign national staff which supports officers in both Warsaw and Budapest.

Secretary Mosbacher has committed to 32 additional FSC positions in the Soviet Union over the next few years, and we are currently working with the Congress to find the resources for these positions.

Business interest in our efforts has been extremely high. A recent telecommunication mission to Poland was oversubscribed and we had to turn companies away. The upcoming Budapest spring fair in which the United States has tripled its exhibit space has a long waiting list of U.S. companies hoping to get in. The Leipzig spring fair which was held about 2 weeks ago had twice the United States participation of last year.

Small business is an extremely important part of our efforts because many of the emerging private sector opportunities in Eastern Europe will begin on a small scale and are well suited for small- and medium-sized companies. It is important to note, however, that East European markets are not for everyone. Eastern Europe is no place for the inexperienced exporter.

We believe there are growing opportunities for the many thousands of experienced small- and medium-sized U.S. exporters. Even the sophisticated exporter faces a difficult market situation in Eastern Europe because of the infrastructure difficulties I referred to earlier. This is where we hope to provide invaluable assistance with market research, trade leads and data reports, trade missions, catalog and video exhibitions, and other programs and information.

My prepared statement goes into greater detail on opportunities in the Soviet Union. I would just quickly say here that the Soviet Union obviously has enormous potential as the world's largest unexplored market, but the Soviet Union remains an extremely difficult place to do business, especially for small companies.

I would also say that their economic reform program is lagging behind those of Eastern Europe. The short-run opportunities for firms lie primarily in increasing their share of what is now a limited market. We are establishing a series of exchanges between U.S. companies and Soviet cooperatives in specific sectors which hold promise such as consumer goods, food processing equipment, medical equipment, construction equipment, and oil and gas equipment.

I will end my remarks at this point, and I look forward to your questions.

[The prepared statement of Mr. Duesterberg follows:]

PREPARED STATEMENT OF
HONORABLE THOMAS J. DUESTERBERG
ASSISTANT SECRETARY OF COMMERCE
FOR INTERNATIONAL ECONOMIC POLICY

BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS
MARCH 23, 1990

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM PLEASED TO BE WITH YOU TODAY TO DISCUSS U.S. TRADE AND ECONOMIC RELATIONS WITH EASTERN EUROPE AND THE SOVIET UNION, AND THE ROLE THAT U.S. SMALL BUSINESSES CAN PLAY. THE U.S. FINDS ITSELF AT AN HISTORIC JUNCTURE IN ITS RELATIONS WITH THESE COUNTRIES, AND THE DIFFERENCE IN OUR OVERALL FOREIGN POLICY APPROACH TO THESE COUNTRIES IS REFLECTED IN THE DIFFERING APPROACH WE TAKE IN DEVELOPING OUR TRADE POLICY.

EASTERN EUROPE

AS THE PRESIDENT NOTED SEVERAL MONTHS AGO, 1989 HAS REPLACED 1945 AS THE REFERENCE POINT FROM WHICH EUROPEAN AFFAIRS, AND THE ROLE THE U.S. WILL PLAY IN EUROPE, WILL BE MEASURED. THIS PAST YEAR HAS SEEN ONE EAST EUROPEAN NATION AFTER ANOTHER REJECT THE TYRANNY OF COMMUNISM AND SINGLE PARTY RULE IN FAVOR OF THE PROMISE OF DEMOCRACY. IN DOING SO, THEY HAVE ALSO REJECTED MARXIST ECONOMIC STRUCTURES BASED ON STATE OWNERSHIP AND CENTRAL PLANNING. A RENEWED BELIEF THAT ONLY FREE MARKETS CAN BRING TRUE ECONOMIC PROSPERITY HAS SWEPT EASTERN EUROPE.

SOME COUNTRIES ARE AT PRESENT MORE COMMITTED TO SUCH A COURSE THAN OTHERS. SOME COUNTRIES ARE FURTHER AHEAD IN CREATING THE APPROPRIATE LAWS AND INSTITUTIONS THAN OTHERS. HOWEVER, I BELIEVE THEY ALL RECOGNIZE THAT THERE IS NO OTHER ALTERNATIVE. HALF-WAY MEASURES WILL NOT WORK.

THE MOST CRUCIAL STEP THESE NASCENT MARKET ECONOMIES CAN TAKE IS TRADE LIBERALIZATION IN THE CONTEXT OF FULL INTEGRATION INTO THE WESTERN ECONOMIC SYSTEM. FOR FAR TOO MANY YEARS THESE NATIONS HAVE OPERATED AS ESSENTIALLY CLOSED ECONOMIES. THIS HAS LEFT THEM WITH A LARGELY INEFFICIENT INDUSTRIAL STRUCTURE. THEIR ECONOMIES MUST SHIFT FROM PRODUCING A WIDE VARIETY OF PRODUCTS FOR THEIR SMALL MARKETS AND CONCENTRATE THEIR RESOURCES ON INDUSTRIES WHERE THEY EITHER HAVE OR CAN DEVELOP A COMPETITIVE ADVANTAGE. THIS CAN NOT HAPPEN THROUGH INDUSTRIAL PLANNING AND STATE CONTROLS. THE DISCIPLINE OF AN OPEN AND COMPETITIVE MARKET IS NECESSARY.

WITH THE BLOSSOMING OF THAT OPEN MARKET, EASTERN EUROPE IS WELL ON ITS WAY TO BECOMING THE NEW FRONTIER FOR PRIVATE ENTERPRISE, INVESTMENT, AND SMALL BUSINESS. PREVIOUSLY THE DOMAIN OF A SELECT GROUP OF COMPANIES WITH A SPECIAL INTEREST IN EASTERN EUROPE OR LONG STANDING BUSINESS RELATIONSHIPS, THE REGION HAS EXPERIENCED AN EXPLOSION OF U.S. COMPANY INTEREST.

THE U.S. PRIVATE SECTOR CAN AND MUST PLAY A KEY ROLE IN THE RECOVERY EFFORT THAT IS TAKING PLACE IN EASTERN EUROPE. THE INFUSION OF AMERICAN ENTREPRENEURIAL SPIRIT, MANAGEMENT AND ORGANIZATION SKILLS, AND MANUFACTURING AND TECHNOLOGICAL CREATIVITY CAN BE IMPORTANT TO THE LONG TERM SUCCESS OF POLITICAL, ECONOMIC AND SOCIAL REFORM IN EASTERN EUROPE. MANY OF THESE SKILLS AND RESOURCES RESIDE IN THE DYNAMIC SMALL BUSINESS COMMUNITY IN THIS COUNTRY.

WE MUST, HOWEVER, BE AWARE THAT ECONOMIC CHANGES OCCUR MUCH MORE SLOWLY THAN POLITICAL ONES. THE BIRTH OF A DEMOCRACY CAN OCCUR QUICKLY, OFTEN BY REVOLUTION, PEACEFUL OR OTHERWISE, AS WE HAVE SEEN IN SOME EASTERN EUROPEAN NATIONS. BUT AN ECONOMIC REVOLUTION TAKES TIME, PATIENCE, AND COMMITMENT. IN RECENT MONTHS, I HAVE BEEN TO POLAND, HUNGARY, CZECHOSLOVAKIA, AND THE GDR. I HAVE MET WITH THE NEW LEADERS OF THESE COUNTRIES, AND I HAVE LITTLE DOUBT THAT THEY HAVE THE COURAGE AND COMMITMENT FOR THE DAUNTING TASK AHEAD.

THE NEW GENERATION OF LEADERS IN EASTERN EUROPE HAVE BEEN LEFT WITH INEFFICIENT AND UNCOMPETITIVE INDUSTRIES, OUTDATED TECHNOLOGIES, POLLUTED ENVIRONMENTS, AND COST AND PRICE STRUCTURES WHICH HAVE GROSSLY MISALLOCATED THEIR ECONOMIC AND HUMAN RESOURCES. THEY HAVE INHERITED A SYSTEM OF ECONOMIC SCARCITY THAT COULDN'T PRODUCE ADEQUATE QUANTITIES OF GOODS AND SERVICES, A SYSTEM THAT DESTROYED INITIATIVE AND CREATIVITY.

THE FIRST PROBLEM THESE NEW LEADERS MUST CONFRONT IS THE CREATION OF THE NECESSARY INFRASTRUCTURE FOR A MARKET ECONOMY. THE COUNTRIES OF EASTERN EUROPE LACK THE NECESSARY LEGAL AND ACCOUNTING STRUCTURE TO SUPPORT EVEN THE MOST BASIC MARKET ECONOMY. THE COMMUNICATION, TRANSPORTATION, AND DISTRIBUTION SYSTEMS ARE WOEFULLY INADEQUATE. WHOLESALE MARKETS IN MANY INSTANCES SIMPLY DO NOT EXIST. WITHOUT THIS INFRASTRUCTURE, OTHER PROGRAMS WILL FAIL.

THE U.S. CAN, AND I BELIEVE MUST, PLAY A VITAL ROLE IN HELPING THE NEW DEMOCRACIES IN EASTERN EUROPE REBUILD THEIR ECONOMIC INFRASTRUCTURE. THIS IS NOT ONLY SOUND FOREIGN AND COMMERCIAL POLICY, AND THEREFORE IN OUR NATION'S BEST INTEREST, BUT IT IS ALSO IN THE BEST INTEREST OF U.S. COMPANIES SEEKING TO DO BUSINESS IN AN INCREASINGLY INTEGRATED EUROPE.

WE MUST ALSO BE VERY AWARE OF THE SIZE AND COMPOSITION OF THE MARKETS IN EASTERN EUROPE. IN 1989, THE COMBINED TOTAL OF U.S. EXPORTS TO THE SEVEN NATIONS OF EASTERN EUROPE WAS JUST OVER $1 BILLION, ROUGHLY THE SIZE OF OUR TOTAL EXPORTS TO NORWAY. OUR LARGEST MARKET IN EASTERN EUROPE WAS POLAND, WHERE U.S. MERCHANDISE EXPORTS WERE $414 MILLION.

THE U.S. ACCOUNTED FOR 5 PERCENT OF TOTAL HARD CURRENCY EXPORTS TO EASTERN EUROPE, WHILE WESTERN EUROPE ACCOUNTED FOR 90 PERCENT. U.S. MARKET SHARE IN EASTERN EUROPE RANGED FROM 2 PERCENT IN HUNGARY AND CZECHOSLOVAKIA TO AS HIGH AS 16 PERCENT IN ROMANIA.

THIS DOES NOT MEAN, HOWEVER, THAT THERE ARE NOT SUBSTANTIAL OPPORTUNITIES FOR U.S. TRADE AND INVESTMENT IN THE REGION. WHILE THE DOMINANCE OF WESTERN EUROPE IN THE EASTERN EUROPEAN MARKET CONTINUES A HISTORICAL TREND, WE FEEL THERE ARE VERY REAL OPPORTUNITIES FOR U.S. FIRMS TO INCREASE EXPORTS TO, AND MARKET SHARE IN, THIS REGION. THIS WILL, HOWEVER, REQUIRE CONSIDERABLE EFFORT, AND I WILL ADDRESS THE DEPARTMENT'S PROGRESS IN THAT AREA LATER IN MY TESTIMONY.

EAST EUROPEAN NATIONS ARE ALSO SHOWING A STRONG INTEREST IN ATTRACTING INVESTMENT AND JOINT VENTURE PARTNERS FROM THROUGHOUT THE WESTERN WORLD. IN POLAND, FOR EXAMPLE, THERE ARE ROUGHLY 900 JOINT VENTURES, HALF OF WHICH ARE WITH WEST GERMAN PARTNERS AND 60 WITH U.S. PARTNERS. SECTORS WITH THE MOST JOINT VENTURE ACTIVITY INCLUDE FOOD PROCESSING, CONSTRUCTION AND RELATED MATERIALS, AND MACHINE TOOLS. HUNGARY HAS BETWEEN SIX AND SEVEN HUNDRED JOINT VENTURES, CONCENTRATING IN CONSUMER GOODS AND SERVICES. A U.S. FIRM IS THE PARTNER IN APPROXIMATELY 150 OF THESE.

AT THE OTHER END OF THE SPECTRUM ARE COUNTRIES LIKE CZECHOSLOVAKIA, ROMANIA, AND THE GDR WITH ONLY A HANDFUL OF OPERATIONAL JOINT VENTURES. I WOULD LIKE TO NOTE HERE THAT THE GDR PASSED ITS FIRST JOINT VENTURE LAW ON JANUARY 30, 1990.

ONE OF THE PRIMARY BARRIERS TO THE FORMATION OF JOINT VENTURES IS THE DIFFERENT, AND SOMETIMES UNREALISTIC, EXPECTATIONS OF THE EASTERN AND WESTERN PARTNERS. THE EASTERN PARTNERS GENERALLY CONSIDER JOINT VENTURES AS AN OPPORTUNITY TO EARN HARD CURRENCY THROUGH EXPORTS, WHILE THE WESTERN PARTNERS ARE USUALLY LOOKING FOR A FOOTHOLD IN THE DOMESTIC MARKET WHERE THE JOINT VENTURE IS LOCATED.

COMMERCE EFFORTS IN EASTERN EUROPE

WITH THIS AS BACKGROUND, MR. CHAIRMAN, LET ME TURN TO WHAT WE AT THE DEPARTMENT OF COMMERCE ARE DOING TO BUILD A COMMERCIAL RELATIONSHIP WITH THE NATIONS OF EASTERN EUROPE. MANY GOVERNMENT AGENCIES ARE ENGAGED IN THE HISTORIC U.S. EFFORT TO ASSIST EASTERN EUROPE. THE DEPARTMENT OF COMMERCE HAS A PARTICULARLY IMPORTANT TASK, THAT OF BUILDING THE COMMERCIAL STRUCTURE, AND THE ROLE OF U.S. BUSINESS IN THAT STRUCTURE, IN EASTERN EUROPE.

OUR APPROACH TO THIS KEY TASK IS THREE-FOLD. THE FIRST IS TO FOSTER THE CREATION OF THE INFRASTRUCTURE IN EASTERN EUROPE NECESSARY TO DEVELOP AND SUSTAIN A MARKET ECONOMY. THE SECOND IS TO BUILD AN AWARENESS IN THE U.S. BUSINESS COMMUNITY OF THE CHANGES AND OPPORTUNITIES IN EASTERN EUROPE, AND THE THIRD IS TO ASSIST THESE COMPANIES IN BUILDING BUSINESS IN THESE MARKETS. I WOULD LIKE TO ADDRESS THESE THREE AREAS IN TURN.

THE DEPARTMENT HAS FOCUSED ITS EFFORTS IN THE FIRST AREA ON TWO FUNCTIONS. WE ARE WORKING WITH THE GOVERNMENTS IN EASTERN EUROPE IN THEIR EFFORTS TO BUILD THE INFRASTRUCTURE FOR A MARKET ECONOMY. THIS HAS BEEN THE CENTRAL THEME OF SECRETARY MOSBACHER'S VISITS TO POLAND, HUNGARY, AND CZECHOSLOVAKIA. HIS GOAL HAS BEEN TO ASSIST THE NEW LEADERS OF THESE COUNTRIES IN RECOGNIZING THE IMPORTANCE OF MOVING AS RAPIDLY AS POSSIBLE TOWARD ECONOMIC LIBERALIZATION AND THE CREATION OF THIS INFRASTRUCTURE. WITH THIS OVERALL OBJECTIVE IN MIND, THE DEPARTMENT HAS PLANNED LEGAL AND ACCOUNTING SEMINARS TO EXCHANGE INFORMATION ON THE LEGAL FRAMEWORK AND ACCOUNTING PRACTICES IN POLAND AND HUNGARY, AND TO OFFER ADVICE ON NEEDED REFORMS.

THE OTHER ASPECT WE HAVE CONCENTRATED ON IS THE NEGOTIATION OF COMPREHENSIVE BUSINESS AND ECONOMIC AGREEMENTS WITH POLAND AND HUNGARY. THE INITIAL IMPETUS FOR THESE ACCORDS CAME ON THE SECRETARY'S VISIT TO THESE COUNTRIES, DURING WHICH HE URGED THE NEW LEADERSHIP TO ENTER INTO NEGOTIATIONS TOWARD ACHIEVING COMPREHENSIVE AGREEMENTS. I AM PLEASED TO SAY THE PRESIDENT SIGNED THE TREATY ON BUSINESS AND ECONOMIC RELATIONS WITH POLAND AT THE WHITE HOUSE ON WEDNESDAY.

WE BELIEVE THIS AGREEMENT WILL DO MORE THAN ANYTHING ELSE TO CREATE A CLIMATE IN WHICH AMERICAN BUSINESS WOULD BE WILLING TO OPERATE. THIS AGREEMENT COVERS INVESTMENT PROTECTION PROVISIONS, SUCH AS REPATRIATION OF PROFITS, GUARANTEES AGAINST EXPROPRIATION, ARBITRATION CLAUSES, INTELLECTUAL PROPERTY RIGHTS, AND THE LIKE. IT ALSO ADDRESSES THE BUSINESS FACILITATION INFRASTRUCTURE THAT IS NEEDED -- SUCH AS THE ABILITY TO OPEN OFFICES AND SELECT DISTRIBUTORS.

LET ME NOW TURN TO THE SECOND AREA IN OUR EFFORTS -- THE NEED TO CREATE AN AWARENESS WITHIN THE U.S. BUSINESS COMMUNITY OF THE OPPORTUNITIES IN EASTERN EUROPE.

IT WAS WITH THIS NEED IN MIND THAT THE DEPARTMENT OPENED THE EASTERN EUROPE BUSINESS INFORMATION CENTER (EEBIC). THIS IS THE CENTER CALLED FOR IN THE SUPPORT FOR EAST EUROPEAN DEMOCRACY (SEED) ACT OF 1989. SINCE ITS OPENING ON JANUARY 23, EEBIC HAS TAKEN OVER 7000 PHONE CALLS FROM AMERICAN COMPANIES, THE VAST MAJORITY OF THEM FROM SMALL AND MEDIUM SIZE FIRMS. EEBIC SERVES AS THE FEDERAL GOVERNMENT'S CENTRAL CLEARINGHOUSE FOR INFORMATION ON (1) BUSINESS NEEDS AND OPPORTUNITIES IN EASTERN EUROPE AND (2) VOLUNTARY ASSISTANCE TO EAST EUROPEAN COUNTRIES. BRANCHES OF THIS CENTER WILL BE OPENING IN WARSAW AND BUDAPEST, WHERE THEY WILL BE INTEGRATED WITH EXISTING U.S. & FOREIGN COMMERCIAL SERVICE OPERATIONS.

THE CENTER PROVIDES A BROAD RANGE OF INFORMATION TO INTERESTED AMERICAN COMPANIES. IT PROVIDES BUSINESS COUNSELING, INFORMATION PACKAGES, AND REFERS CALLS TO INDUSTRY AND COUNTRY SPECIALISTS. EEBIC IS DEVELOPING A DATABASE OF COMPANIES THAT HAVE REQUESTED INFORMATION. THIS LIST WILL BE USED TO HELP FURTHER EXPAND AND TARGET OUR TRADE PROMOTION ACTIVITIES. A PERIODICAL NEWS BULLETIN ON EASTERN EUROPE IS CURRENTLY UNDER DEVELOPMENT. THIS BULLETIN WILL BE DISTRIBUTED TO COMPANIES IN THE DATABASE TO KEEP THEM ABREAST OF COMMERCIAL DEVELOPMENTS IN THE REGION.

I WANT TO TURN NOW TO OUR THIRD AND MOST IMPORTANT PRIORITY, WHICH IS THE DEPARTMENT'S EFFORTS TO EXPAND U.S. BUSINESS PRESENCE AND INVOLVEMENT IN THIS NEW MARKET.

THE BASIC INFRASTRUCTURE OF A MARKET ECONOMY IS NOT THE ONLY COMMERCIAL NECESSITY LACKING IN EASTERN EUROPE. BASIC INFORMATION IS DIFFICULT, IF NOT IMPOSSIBLE, TO FIND AS WELL. THERE ARE NO BUSINESS REGISTERS, YELLOW PAGES, OR DUN & BRADSTREET LISTINGS. A MARKET CANNOT FUNCTION WITHOUT THIS TYPE OF INFORMATION.

THE DEPARTMENT OF COMMERCE IS PLANNING A MAJOR INCREASE IN TRADE PROMOTION AND BUSINESS ASSISTANCE EFFORTS IN EASTERN EUROPE TO ADDRESS THIS VERY PROBLEM. WE ARE DEVELOPING A WIDE RANGING SERIES OF "DOING BUSINESS IN EASTERN EUROPE" SEMINARS TO BE SPONSORED ACROSS THE U.S. BY THE COMMERCE DEPARTMENT'S US&FCS DISTRICT OFFICES. NEW PUBLICATIONS ON DOING BUSINESS IN EASTERN EUROPE ARE BEING DEVELOPED. THE US&FCS IS ALSO EXPANDING THE NUMBER AND VARIETY OF TRADE PROMOTION PROGRAMS HELD IN EASTERN EUROPEAN NATIONS AND IS TAILORING THEM TO THE SPECIFIC MARKETS, HAS ASSIGNED SENIOR COMMERCIAL OFFICERS TO PRAGUE AND BERLIN, AND IS DOUBLING THE FOREIGN NATIONALS STAFF THAT SUPPORTS OUR COMMERCIAL OFFICERS IN BOTH WARSAW AND BUDAPEST.

BUSINESS INTEREST IN OUR EFFORTS HAS BEEN HIGH. A RECENT TELECOMMUNICATIONS MISSION TO POLAND WAS OVERSUBSCRIBED, AND WE HAD TO TURN COMPANIES AWAY. THE UPCOMING BUDAPEST SPRING FAIR, IN WHICH THE U.S. HAS TRIPLED ITS EXHIBIT SPACE, HAS A LONG WAITING LIST OF U.S. COMPANIES STILL HOPING TO GET IN. THE LEIPZIG SPRING FAIR, AT WHICH I HAD THE PRIVILEGE TO REPRESENT THE DEPARTMENT EARLIER THIS MONTH, HAD TWICE THE U.S. PARTICIPATION AS LAST YEAR.

AS THE EASTERN EUROPEAN ECONOMIES BECOME MORE MARKET ORIENTED, WE WILL BE ABLE TO APPLY THE TOOLS THAT WE HAVE SUCCESSFULLY USED IN OTHER AREAS OF THE WORLD TO ASSIST U.S. EXPORTERS. SMALL BUSINESS IS AN IMPORTANT PART OF OUR EFFORTS, BECAUSE MANY OF THE EMERGING PRIVATE SECTOR BUSINESS OPPORTUNITIES IN EASTERN EUROPE WILL BEGIN ON A SMALL SCALE AND ARE WELL SUITED FOR SMALL AND MEDIUM SIZED AMERICAN COMPANIES.

IT IS IMPORTANT TO NOTE, HOWEVER, THAT EAST EUROPEAN MARKETS ARE NOT FOR EVERYONE. EASTERN EUROPE IS NO PLACE FOR THE INEXPERIENCED EXPORTER. BUT WE BELIEVE THERE ARE GROWING OPPORTUNITIES FOR THE MANY THOUSANDS OF EXPERIENCED SMALL AND MEDIUM SIZED U.S. EXPORTERS. EVEN SOPHISTICATED EXPORTERS, THOUGH, FACE A DIFFICULT MARKET SITUATION IN EASTERN EUROPE BECAUSE OF THE INFRASTRUCTURE DIFFICULTIES I REFERRED TO EARLIER. THIS IS WHERE THE DEPARTMENT OF COMMERCE IS ABLE TO PROVIDE INVALUABLE ASSISTANCE -- WITH MARKET RESEARCH, TRADE LEADS AND DATA REPORTS, TRADE MISSIONS, CATALOG & VIDEO EXHIBITIONS, AND OTHER PROGRAMS AND INFORMATION.

THERE IS ONE PROJECT I WOULD LIKE TO PARTICULARLY POINT OUT BECAUSE WE BELIEVE IT HAS THE POTENTIAL TO PROVIDE VALUABLE ASSISTANCE TO THE SMALL EXPORTER. THIS IS A PROGRAM TO INCREASE THE USE OF EXPORT TRADING COMPANIES AND EXPORT MANAGEMENT COMPANIES. THE INCIPIENT PRIVATE SECTORS IN EASTERN EUROPE OFFER MANY OPPORTUNITIES FOR SMALL AMERICAN COMPANIES AS PARTNERS, AND WE BELIEVE THAT THERE IS A MAJOR ROLE FOR EXPORT TRADING AND MANAGEMENT COMPANIES TO SERVE AS SOURCING AND SUPPLYING AGENTS TO CREATE BUSINESS HERE. WEST EUROPEANS HAVE THE ADVANTAGE OF BEING LOCATED NEXT TO THE EAST EUROPEAN MARKETS, AND AMERICAN COMPANIES -- PARTICULARLY SMALLER ONES -- NEED THESE SPECIALIZED TRADING COMPANIES TO ENABLE THEM TO COMPETE FOR THE NEW BUSINESS OPPORTUNITIES IN EASTERN EUROPE.

USSR

MR. CHAIRMAN, LET ME TURN MY ATTENTION NOW TO THE USSR. MAJOR CHANGES HAVE ALSO BEEN OCCURRING IN THE SOVIET UNION, THOUGH THE PACE OF CHANGE HAS BEEN SLOWER, THE SCOPE MORE RESTRICTED, AND THE EFFECT LESS DRAMATIC. IN A MAJOR DEPARTURE FROM THE TRADITIONAL SOVIET VIEW, PRESIDENT GORBACHEV HAS ANNOUNCED A GOAL OF INTEGRATING THE SOVIET ECONOMY INTO THE WORLD ECONOMIC SYSTEM. HE SEEKS TO END THE SOVIET UNION'S AGE OF ECONOMIC ISOLATION.

UNDER PRESIDENT BUSH'S LEADERSHIP, THE UNITED STATES HAS BEGUN EFFORTS TO IMPROVE OUR TRADE RELATIONSHIP WITH THE SOVIET UNION, INCLUDING THE NEGOTIATION OF TRADE AND INVESTMENT AGREEMENTS.

THE DEPARTMENT OF COMMERCE IS WORKING CLOSELY WITH USTR, THE STATE DEPARTMENT, AND OTHER AGENCIES IN NEGOTIATIONS WITH THE USSR. OUR ROLE IS TO ENSURE THE TRADE AGREEMENT WITH THE SOVIET UNION SERVES U.S. ECONOMIC AND COMMERCIAL INTERESTS. THIS MEANS THAT THE AGREEMENT MUST DO MORE THAN GRANT RECIPROCAL MOST FAVORED NATION STATUS, FOR THAT WOULD MEAN LITTLE TO U.S. COMPANIES UNDER CURRENT CIRCUMSTANCES. WE ARE ACTIVELY SEEKING BUSINESS FACILITATION PROVISIONS THAT WOULD ENHANCE U.S. COMMERCIAL ACCESS TO, AND COMMERCIAL SUCCESS IN, THE SOVIET MARKET.

WHAT ARE U.S. AND OTHER WESTERN FIRMS FACED WITH IN THE SOVIET MARKET? IN THE SHORT RUN THE SOVIET UNION IS IN WHAT COULD ONLY BE CHARACTERIZED AS A VERY UNCOMFORTABLE POSITION, PART WAY BETWEEN A CENTRALLY PLANNED AND ADMINISTERED SYSTEM AND A DECENTRALIZED SYSTEM RESPONDING TO MARKET FORCES. SOVIET MINISTRIES AND ENTERPRISES ARE RECEIVING AND SENDING CONFUSED SIGNALS. IN FOREIGN TRADE, IN PARTICULAR, MANY ARE NOT ONLY INEXPERIENCED BUT UNSURE ABOUT THEIR AUTHORITY. THUS THE BUSINESS ENVIRONMENT FOR U.S. AND OTHER WESTERN COMPANIES IS CONFUSED.

TWO WAY TRADE BETWEEN THE U.S. AND THE SOVIET UNION REACHED $5 BILLION IN 1989, WITH A $3.5 BILLION SURPLUS IN FAVOR OF THE U.S. OUR EXPORTS TO THE SOVIET UNION TOTALLED NEARLY $4.3 BILLION, THE HIGHEST LEVEL IN THE HISTORY OF U.S.-SOVIET TRADE. IT IS IMPORTANT TO NOTE, HOWEVER, THAT 80 PERCENT OF THESE EXPORTS WERE AGRICULTURAL GOODS, MOSTLY CORN, WHEAT, AND SOYBEANS.

THE SOVIET UNION IS THE WORLD'S LARGEST UNEXPLORED MARKET. ITS ECONOMIC STRENGTHS LIE IN ITS WEALTH OF RAW MATERIALS AND TREMENDOUS POTENTIAL AS A CONSUMER MARKET. THIS POTENTIAL, COMBINED WITH THE RECENT SOCIAL AND POLITICAL CHANGES, HAS GENERATED A GREAT DEAL OF BUSINESS INTEREST, FROM BOTH LARGE AND SMALL COMPANIES ALIKE. BUT THE SOVIET UNION REMAINS AN EXTREMELY DIFFICULT PLACE TO DO BUSINESS, ESPECIALLY FOR SMALL COMPANIES. THE SUCCESSFUL U.S. BUSINESS IN THE SOVIET MARKET MUST BE ABLE TO MAKE A LONG TERM COMMITMENT AND INVESTMENT.

IN THIS ENVIRONMENT, THE SHORT RUN OPPORTUNITIES FOR U.S. FIRMS LIE PRIMARILY IN INCREASING THEIR SHARE OF WHAT IS NOW A LIMITED MARKET. IT IS IMPORTANT TO RECOGNIZE THAT WHILE THE SOVIET UNION IS ONE OF THE WORLD'S LARGEST ECONOMIES, ITS HARD CURRENCY EXPORT EARNINGS ARE ONLY ABOUT $30 BILLION ANNUALLY -- ABOUT THE SIZE OF DENMARK'S. IN THE LONGER TERM, HOWEVER, THE MEASURES TAKEN BY THE SOVIETS TO OPEN THEIR MARKET SHOULD EVENTUALLY EXPAND BUSINESS OPPORTUNITIES.

BEARING THESE DIFFICULTIES IN MIND, WE REMAIN OPTIMISTIC ABOUT OPPORTUNITIES IN SEVERAL SPECIFIC SECTORS OF U.S.-SOVIET TRADE -- CONSUMER GOODS, FOOD PROCESSING EQUIPMENT, MEDICAL EQUIPMENT, CONSTRUCTION EQUIPMENT, AND OIL & GAS EQUIPMENT. UNDER THE AUSPICES OF THE JOINT U.S.-U.S.S.R. COMMERCIAL COMMISSION (JCC), WHICH IS CO-CHAIRED BY THE SECRETARY OF COMMERCE AND THE SOVIET MINISTER OF FOREIGN ECONOMIC RELATIONS, WE HAVE ESTABLISHED A NUMBER OF BILATERAL WORKING GROUPS TO PROMOTE COMMERCIAL COOPERATION IN THESE SECTORS. OUR GOAL IS TO HELP AMERICAN COMPANIES UNDERSTAND HOW TO DO BUSINESS IN A CHANGING SOVIET UNION AND BRING THEM INTO CONTACT WITH POTENTIAL SOVIET BUSINESS PARTNERS.

WITH THIS GOAL IN MIND, THE DEPARTMENT IS ESTABLISHING A SERIES OF EXCHANGES BETWEEN U.S. COMPANIES AND SOVIET COOPERATIVES. THE VAST MAJORITY OF THESE SOVIET COOPERATIVES ARE ESSENTIALLY SMALL BUSINESSES, AND THIS PROGRAM WILL PROVIDE AN EXCELLENT OPPORTUNITY FOR SMALL BUSINESSES IN THE UNITED STATES TO FIND A MARKET NICHE, OR PERHAPS A JOINT VENTURE PARTNER, IN THE SOVIET UNION.

NEARLY 1500 JOINT VENTURES ARE REGISTERED IN THE SOVIET UNION, BUT ONLY A LITTLE MORE THAN 10 PERCENT ARE OPERATIONAL. THE U.S. IS THE THIRD MOST ACTIVE PARTICIPANT, WITH APPROXIMATELY 120 REGISTERED JOINT VENTURES, BEHIND WEST GERMANY AND FINLAND.

IF THERE IS ONE FUNDAMENTAL TRUTH ABOUT DOING BUSINESS IN THE SOVIET UNION, IT IS THAT A FIRM MUST "DO ITS HOMEWORK." THIS IS PARTICULARLY TRUE FOR SMALL BUSINESSES, GIVEN THEIR MORE LIMITED RESOURCES AND OFTEN MORE SPECIALIZED MARKET NICHE. I HAVE BROUGHT WITH ME TODAY COPIES OF A RECENT DEPARTMENT OF COMMERCE PUBLICATION ENTITLED INTRODUCTORY GUIDE TO JOINT VENTURES IN THE SOVIET UNION. THIS GUIDE, WHICH IS AVAILABLE THROUGH THE GOVERNMENT PRINTING OFFICE, IS A VALUABLE RESOURCE FOR U.S. COMPANIES SEEKING TO ENTER THE SOVIET MARKET.

CONCLUSION

THE U.S. DEPARTMENT OF COMMERCE IS ACTIVELY INVOLVED IN PROMOTING, AND PROTECTING, U.S. BUSINESS AND COMMERCIAL INTERESTS IN EASTERN EUROPE AND THE SOVIET UNION. THESE ARE IMPORTANT NEW MARKETS, WITH TREMENDOUS POTENTIAL FOR U.S. COMPANIES BOTH LARGE AND SMALL.

THANK YOU, MR. CHAIRMAN.

Senator LIEBERMAN. Thank you for your testimony. I appreciate the balance you present in your remarks. You clearly state that there is an opportunity here for American business, but getting involved there is not for every American business, and it is not without some difficulty for the reasons you stated in the nations of Eastern Europe.

It seems to me that we should be moving along two channels. One is by offering technical assistance. For instance, we can do this by having American business executives provide counsel to the nations of Eastern Europe. By doing this, we will help to create the kind of economic infrastructure that will be more hospitable and more profitable for American business.

Second, we are trying to counsel American businesses about getting involved.

For instance, if I was the president of a company in Connecticut and manufactured widgets, let us say consumer widgets of some kind, and I read about the enormous changes in Eastern Europe and saw the potential for selling my product there. Who do I go to in our Government for help?

Mr. DUESTERBERG. I would suggest that the first stop be the Connecticut office of the Foreign Commercial Service, which is there precisely for the purpose of providing introductory information, if you will, on the opportunities that exist abroad.

Senator LIEBERMAN. Which is a section of the Department of Commerce and exists in every State.

Mr. DUESTERBERG. I believe that it exists in 48 states, if I am not mistaken. They are in touch with the network for Foreign Commercial Service officers abroad and also the central repositories of information here in Washington. They can provide certain pieces of information which are tailored to specific countries. We can do elementary sorts of market research. We can put people in touch with distributors, and we have data bases of foreign companies that are looking for joint venture partners and import-export partners.

Senator LIEBERMAN. What questions should I ask myself about whether I should go into Eastern Europe with this consumer widget product of mine?

Mr. DUESTERBERG. Well, as I tried to point out in my remarks and my colleagues have pointed this out as well, not every Eastern European country or the Soviet Union is as far advanced in their economic reform program as other countries. The situation is different for doing business there than it is almost anywhere else in the world. So you have to inform yourself about the climate for doing business, first of all.

Second, you have to start investigating the specific market niche in which you would like to sell. Our network of Foreign Commercial Service officers can get one started in acquiring that information. They can provide certain leads on market research, and we do a limited amount of market research ourselves.

Then at that point if there is still an interest, we can help put the potential exporter in touch with people on the ground in the country in which they wish to do business.

Senator LIEBERMAN. Let me just pick up on something else that you said, which I have also heard in some of my conversations with people doing business in Eastern Europe. Right now, American business is a relatively small factor in the East European market compared to the West Europeans. I think you quite dramatically stated that, and the numbers suggest that.

There seems to be an interest on the part of the Eastern Europeans in having more American involvement in their markets so that their markets will not be dominated by one country. Am I hearing you correctly?

Mr. DUESTERBERG. Yes, sir, you are. At the risk of oversimplifying, and I ask my colleagues to comment on this, the East European countries especially have gone through a period where they have been dominated politically and to a certain extent economically by their neighbors to the East and, earlier than that perhaps, to the West. They are acutely conscious of that.

Everywhere I have been in Eastern Europe there has been expressed desire to have American investment to diversify their markets and to serve, if you will, as a counterweight to the other historical influences.

Senator LIEBERMAN. Is trade with Eastern Europe going to be a kind of back door into European Community 1992 for American business?

Mr. DUESTERBERG. I think that's certainly a possibility. I have talked to a few businesses who are already established in Eastern Europe who at least have that in the back of their mind in their long-range business planning.

Senator LIEBERMAN. To continue with the same line of reasoning, I have noted the increasing involvement of the Japanese in Eastern Europe recently. Might that also be a back door for the Japanese into the EC 1992?

Mr. DUESTERBERG. I think that is possible, but the European Community is always aware of the Japanese efforts to penetrate their market. The community is perhaps somewhat more active in taking measures which will make it more difficult, if you will, for the Japanese.

My sense in traveling around Eastern Europe is that the Japanese are not quite as interested there as they are in other parts of the world, and my suspicion is that though they are aware of that possibility of using it as a back door into the European Community, they are concentrating right now on probably investing in the community in places like Spain and the United Kingdom as a point of entry.

Senator LIEBERMAN. To pick up on something you said earlier about the understandable skepticism or reluctance the Eastern Europeans have stemming from their experience of having been by the Russians and, earlier, by the Western Europeans. They want to avoid creating a similar situation now. I had a member of the new Polish Senate in my office about a month ago. We were talking about aid to Eastern Europe, and I said what counsel do you have for the American Government? He said do not give all your aid and support to the Government. It was particularly interesting because he is part of the new government.

He said spread it out, give it to individual businesses, individual subunits of government. So the experience of having suffered under central authority is still very fresh in their minds, and I think it has deeply affected their thinking.

Let me ask a final question before I yield to my colleague. In his testimony before the Senate Finance Committee last October, Secretary Baker said, "We may be able to offer the Soviets some technical economic assistance as they struggle with the massive task of restructuring their economy."

Is that today official U.S. policy? If so, what types of programs are we putting in place to offer the Soviets technical assistance?

Mr. McAllister. That is what we refer to as technical cooperation, and it is very much our policy. The President gave Mr. Gorbachev a list of possibilities. Some of the recent technical cooperation ventures include a small business delegation from the Soviet Union that worked with our SBA in touring the United States. We just had a delegation of Soviets through who spent 10 days in New York at the New York Stock Exchange.

We are also working with them on statistics. We want to talk to them about budgeting and taxes. We very much want to lend our experiences and our expertise to them, and they are interested in doing that.

Senator Lieberman. Thank you. My time is up. With the consent of my colleagues, I would like to call on them in the order in which they arrived. So Senator Burns, it is all yours.

Senator Burns. Thank you, Mr. Chairman.

You just made a statement, Mr. McAllister. Helping them on budget and taxes, that scares me to death.

Mr. McAllister. They are in worse shape than we are.

Senator Burns. I think the Chairman hit upon a note here that sometimes we take the philosophy that if we just throw money at it to shore up the Government to tighten its controls or centralize more to promulgate their own philosophy. Sometimes that has been the downfall of some of our foreign policy as far as assistance goes.

I was wondering. We have an apparatus already set up in the Small Business Administration, a corps of retired executives, and those people are willing and able to assist economic growth, basic economic growth in those countries. It seems that the Director of SBA has sent to the State Department and I think to the U.S. Trade Representative's Office a suggestion of working together on this. SBA focuses on small businesses here in the United States, getting them ready and offering them some type of technical assistance on how to get into those markets, but then when a plan is submitted over to another department that plan is not responded to very quickly.

Do either of you know what the Director of SBA has done in that respect, and have you responded? I would ask, Mr. McAllister or Mr. Duesterberg, if you know anything about that.

Mr. McAllister. Yes, Senator. The President designated Deputy Secretary Eagleburger as the coordinator. The co-coordinators are Deputy Secretary Robson and CEA Chairman Michael Boskin. I know Secretary Eagleburger has met with Mrs. Engeleiter, the head of the SBA, a number of times. He chairs a meeting of a group that meets fairly frequently looking for ideas, casting about for ideas for using the SBA and other Agencies to advance our agenda in Eastern Europe.

So there is a great deal of coordination that is conducted by the Deputy Secretary of State.

Senator BURNS. Do you get the feeling that sometimes in our commercial activities around the world maybe this government gets into the business of micromanaging commercial activities rather than, say, just opening a gate and just letting things happen?

Mr. MCALLISTER. Let me combine this with a point you made earlier. That is very much why we want the enterprise funds to be directed at the private sector. It is not money given by Government to Government. It is funds managed by a separate Board of Governors that will work with the private sector in Poland and Hungary. That is very much what we are trying to do.

A second point is that we have placed a great deal of emphasis on trade and investment agreements simply because the assistance, the aid, has to come through the private sector, and these agreements can facilitate that way.

Senator BURNS. Well, it sounds like you are progressing on some sort of a strategy.

Mr. Duesterberg, in your office over there once you start this process I just want an update of where you think you are as far as the goals and what you would like to attain and if you are making progress along those lines. There has to be some master strategy, I would imagine, in the placement of those plans.

From your standpoint, are we moving fast enough?

Mr. DUESTERBERG. Well, Senator, that is a difficult question to answer. I think, if you will, you have to walk before you can run. We have all today tried to emphasize that the first part of the program is to work with the East European countries to encourage more rapid economic reform.

They have achieved political reform, but in many cases the conditions for doing business are not quite as advanced as we would like them to be. So we are emphasizing at the start working with them to encourage more rapid reform.

Second, we are trying to put resources into place in our Foreign Commercial Service in other places, technical assistance programs that Mr. McAllister just talked about not only with the Soviet Union but with Eastern European countries, exchanges of experts.

We are sponsoring an exchange of legal experts with Poland and Hungary and have already done so with the Soviet Union with the idea of teaching them a little about Western business law, and we are doing the same with accountants. So this whole process is getting under way.

At the same time, we are being pushed by our business community because they are extremely interested in exploring the opportunities. They do not want to get left behind; but we want to be cautious and realistic, if you will, in giving them the best advice we can about the existing conditions because we do not want to get out in front of them and encourage them to do business in a place that is not quite ready for the type of businesses they are used to.

If I can go back to your initial question about this Retired Executive Corps, we have been working with the SBA on opening up opportunities for those executives to go into Eastern Europe. We signed last September a private business agreement with Poland which contemplated using the executives from the SCORE Program on an exchange basis.

I believe the SEED I bill provided money for executive exchanges.

Senator Lieberman probably knows of the International Executive Service Corps.

Senator LIEBERMAN. I sure do. We are very proud of them.

Mr. DUESTERBERG. They are already active in Poland and, I think, in Hungary as well. That is another example of a retired executive group that we are trying to get hooked up with partners in Eastern Europe.

Senator BURNS. It certainly sounds like you are on the right track, and I want to congratulate all of you. In the times we are living in, everything changes from day to day, and nobody knows which way it is really going to go. Nobody could have forecast a year ago that we would even be in the position that we are now. I know it is hard to change any kind of policy or any kind of strategy that we might have had a year ago. It is hard to change that and make it fit to the present conditions. So I want to congratulate you.

Mr. McAllister, I think you are exactly on the right track. I applaud you for that, and if you need any assistance from this office you will certainly get it because I just happen to believe that we have to open the gates and let this American entrepreneur ship work.

I think it will work. I think we can motivate those people. It builds from the ground up instead of from the top down. It is a little slower that way, a little more painful that way. Nonetheless, if the American system and our influence with those people is to be a lasting thing, it has to come from the grassroots up. We can develop those kinds of relationships. I applaud you for that.

Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Burns.

Senator Kasten.

Senator KASTEN. Mr. Chairman, thank you.

Mr. McAllister, I want to focus on the kind of structure that you and others are working through. It seems to me that there is a lot of overlap and a lot of confusion and maybe even some turf battles that are already beginning that are frustrating.

Let me just begin with the Washington Post op. ed. piece of David Broder from March 21 entitled, "What's Polish Democracy Worth?" In that, he said, "there is no question that the American people and Government have given their hearts to the new leaders who freed their lands from Soviet domination," but he goes on to say that, "When the cheering stops, these men and women face daunting challenges against which America's talented resources might make a critical difference. We are not turning our backs on them, but we are not yet geared up to be as helpful, to help, as we should be."

You are all probably familiar with this article. It goes on and explains several months ago, as you just said, the President designated Deputy Secretary of State Lawrence Eagleburger as the coordinator for events in Eastern Europe.

Eagleburger is an able, experienced operative with too much to do, including managing the State Department on the frequent occasions when Secretary of State James Baker is traveling. He has been working in the last couple of weeks on a supplemental with regard to Panama and Nicaragua. All of us understand that it is impossible even to get phone calls returned back and forth simply because he has so many things that are going on in so many places in the world.

His staff can attest that the Eastern European project consists of two enormously overworked people called back from assignments in Ottawa trying to coordinate the work of some 20 separate Government agencies.

Are you one of those two tremendously overworked people called back from Ottawa?

Mr. McAllister. No, sir. I think that greatly understates the amount of resources devoted to this effort in the State Department. Mr. Eagleburger has a small group of people helping him as Coordinator. They are coordinating, I would say, at least 100 people in the State Department and, of course, other agencies around. We have the entire Economic and Business Affairs Bureau working on this as well as the European Affairs Bureau.

Senator Kasten. Explain to me the structure. To whom do you report?

Mr. McAllister. I report to the Secretary through the Under Secretary for Economics.

Senator Kasten. His name is?

Mr. McAllister. Richard McCormack.

Senator Kasten. Is McCormack in this loop?

Mr. McAllister. McCormack is involved in this, yes.

Senator Kasten. You are testifying for him today, in effect? Theoretically, if Eagleburger could not come today the next person in line at the State Department is?

Mr. McAllister. The Chairman invited Secretary Baker. I am testifying on behalf of Secretary Baker.

Senator Kasten. I understand. I am just trying to put together an organizational chart. Secretary Baker is Secretary of State, but Secretary Eagleburger has been designated by the President as the Coordinator.

Now when he has a meeting with regard to trade in Eastern Europe, does he invite you or Mr. McCormack or both of you?

Mr. McAllister. He invites both of us. Mr. McCormack is very much involved right now on Japanese trade issues.

Senator Kasten. And also on debt issues.

Mr. McAllister. So in a sense, I am the major staffperson as Assistant Secretary working on the economic issues related to Eastern Europe.

Senator Kasten. The other two parts of this are Mr. Robson at Treasury and Michael Boskin, neither of whom are represented here.

Now the third part of this evidently is the Small Business Administration, and they are not represented here, either.

Under what circumstances will you or are you working on Senator Burns' question? Do you foresee a role for SBA, not just having a meeting with Secretary Eagleburger? My guess is that would have been one or two meetings of 25 or 30 people. That is not the same as coordinating and working with the Small Business Administration with regard to trade with Eastern Europe.

What are you doing with regard to the Small Business Administration?

Mr. McALLISTER. We are working very closely with them. We are trying to understand what they can do and how that fits into the larger picture.

Senator, I do not think the Deputy Secretary has to spend a lot of time with the head of the SBA to coordinate. All of that can be done at staff level.

Senator KASTEN. Senator Burns referred to a letter that was written on January 5. The Small Business Administration Administrator sent a detailed letter to Mr. Eagleburger explaining a number of different things that the SBA could do to be helpful in expanding trade with Eastern Europe. I have a copy of it. It is now 2½ months later, and there has been no response, to my knowledge.

I am interested in this because I am interested in the SCORE group, and I am also interested in using the Small Business Development Centers and others kinds of groups around the country tying small businessmen and women here to small businessmen and women there, not necessarily in appropriated dollars but the kind of people assistance that the Eastern European parliamentarians with whom I have had an opportunity to work with are asking us for.

It has been 2½ months since that letter was written, and as far as I know there is still no official role for the SBA in this overall arena. Can you explain to me why?

Mr. McALLISTER. I do not know the letter was not responded to. I will go back and make sure there is a response, and I will respond to you and explain our position on that letter. I do not suspect there to be major differences.

What I suspect might have happened is that that letter became part of the policy development process, and it is now in the pool of what the Administration is trying to do on Eastern Europe.

Senator KASTEN. Well, because SBA is primarily a domestic agency, it can only play an official role in expanding trade with Eastern Europe if it is directed to do so by the President or the President's designee. That would be Mr. Eagleburger. The State Department through Mr. Eagleburger is the designee on this issue.

So what you are saying to me is that you do plan to direct the SBA to become directly and actively involved in this issue? Is that what you are saying to me today?

Mr. McALLISTER. My understanding, which I will confirm for you, is that the Deputy Secretary has talked to the Small Business Administrator and asked her to the extent of her legal and statutory capabilities to do as much as she can for Eastern Europe.

Senator KASTEN. That is not the same. She needs to be designated by the President or his official coordinator, and I am asking you if the Small Business Administrator will be so designated?

Mr. McALLISTER. Senator, I believe she probably already has been, although perhaps not on paper.

Senator KASTEN. If she has not been, will she be so designated?

Mr. **McAllister**. Let me go back and talk to Secretary Eagleburger. I will explain to him your great interest in this, and I will get back to you.

Senator **Kasten**. I think the interest is shared by a number of Members on the Committee. This is the Small Business Committee.

Thank you, Mr. Chairman.

Senator **Lieberman**. Thank you, Senator Kasten.

Senator Stevens, welcome, and thank you.

STATEMENT OF HON. TED STEVENS, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator **Stevens**. Thank you very much, Mr. Chairman, and I thank you for holding this hearing. I do hope that I can sort of tilt it a little bit, though, because the hearing is both Soviet Union and the Eastern Europe business opportunities for small businesses. Where I come from, we have been trying to expand relationships with the Soviet Union for some time. In the 1970s our Alaska Airlines actually flew into Soviet Far Eastern Siberia on a daily basis. That was cut off after the problems of Afghanistan.

Today, every small business person from Alaska wants to get into the Soviet Union. There are two opportunities. You can either travel through what we call the South 48 and go over into Western Europe and then go to Moscow and then fly over the Urals and get back into the area which is just 90 miles away, or you can petition Aeroflot for a charter. We now have a charter. As a matter of fact, this Sunday we have 49 small businessmen, the Alaska Trade Mission, going into the Soviet Far Eastern Siberia.

There is daily air service, by the way, from Nome into two small communities in the Soviet Far East. That, too, has some problems because of the fact that we have to have a Soviet navigator every time that plane takes off if it is going to go other than to Magadan.

Now there are tremendous small business opportunities in the Soviet Far Eastern Siberia. I think a lot of people in Washington feel as the people in Moscow do. It is so far away they do not pay much attention to it. We do not have a consulate in the Soviet Far Eastern Siberia, and the Soviets have no one in the Northwest to deal with any visa problems in trying to get into there. As a matter of fact, when Senator Inouye and I go to Vladivostok in April, we will have to fly to Tokyo to pick up a Soviet navigator in order to get into Vladivostok.

We have impediments in dealing with this part of the Soviet Union. It is the part of the Soviet Union that is more attuned to us. I have traveled through that area, Varsk and Hotka, the Siberian railroad.

What I really want to try to do today is to let you know there is a lot going on there. I know some people over there who are operating successfully. Doug Drum from Anchorage has Indian Valley Meats. He is over there operating a sausage plant already. It is a tripartite arrangement. The hard currency is the real problem. He barters some of the processed reindeer and sells it in Korea for hard currency.

We have joint ventures in the Soviet Far East now in fisheries. We have a mining activity going on over there in a joint venture, a small businessman.

I think that there are more small business opportunities in the Soviet Union and the Soviet Far East and Siberia than there are in the western part of the Soviet Union, but to my knowledge none of your agencies has really concentrated in any way and tried to help this expand, either from the Pacific Northwest or from Alaska.

Could you tell me, does the potential of trade with the part of the Soviet Union that is in their eastern zone, that abuts the Pacific, come into your discussions in the State Department or in the Trade Representative or in the Department of Commerce?

We have one person, Mr. Duesterberg, in Alaska that deals with the whole subject of trade with the Pacific. He also has to try to deal with this opening wedge. And the Soviets come into Anchorage almost daily looking for business opportunities, but we cannot reciprocate. We have no way to get back there, except, again, by going around the world to deal with them.

Do the problems of opening this area, this vast area of the Soviet Union, to U.S. small businesses come up in your discussions?

Mr. **Duesterberg**. Senator, we have something called the Joint Commercial Commission, which is headed by the Department of Commerce, with our counterparts in the Soviet Union and which has been meeting with them since about 1972 or so, periodically. And over the years it has been used as a mechanism to discuss problems, but more to discuss business development opportunities.

And in the most recent meeting of this commission, which was held in Washington last September or October, the Soviets brought up the idea of having a working group on developing business ties between our Far West and their Far East.

There has been a bit of speculation over the course of time that what the Soviets had in mind are free economic zones that they might experiment with in Siberia and their Far East. We have been waiting since that time for a specific proposal from them to flesh out this idea. It struck us as an idea that was well worth pursuing given the increasing of trans-Pacific trade and the potential that is there. So I would be happy to go back to them and see if we cannot put some life into this idea.

Senator **Stevens**. My son, who is a commercial fishing boat captain, went with a group of fishing boat people into Japan and then went over to the Soviet Far East to try to negotiate trade ventures. They did work up a joint venture in terms of fishing opportunities over there. They have no assistance whatsoever. They have to wait for a long, long time to get visas through Moscow. They have to come back here to Washington and then go through Moscow, then go out to the Soviet Far East.

If a small businessman from the East Coast wants to go into the western part of the Soviet Union, he can do it almost on a daily basis. He can actually fly into a capital somewhere in one of the Western European countries and wait for a visa. You cannot do that in our part of the world.

I would urge you to realize—you know this is going to be the century of the Pacific. We are coming into a new century. The developing nations of the world, really today in my judgment, are in the

Pacific. They are going to swoop in and develop those relationships to the Soviet Far Eastern Siberia in a way that you cannot believe.

I learned this, Mr. Chairman, just last week—and I will end with this—about an American official, a private businessman who arranged a purchase of Soviet timber to be harvested by Chinese labor, taken to Korea and processed for the Japanese.

Now, the opportunities there in terms of resources and the minerals and the metals, the fisheries, the timber for a voracious developing part of the world there in the Pacific are just overwhelming for our small businesses. And yet, daily, we get calls. How can we get clearances, how can we get the rights to fly in. Why can we not restore the rights that U.S. airlines in the West had to go to the Soviet Far East and Siberia? We have not done so.

Again, I just believe that we are missing the boat, Mr. Chairman. The real opportunities for small business in that area, where people really have a disdain for Moscow. When I was there they just were overwhelmingly outspoken, as we are in Alaska concerning you all, as a matter of fact. I would hope you would try to help us dissidents get together, in effect. And I urge you to try to do it.

Thank you, Mr. Chairman.

Senator LIEBERMAN. Thank you, Senator Stevens. It is the age of dissidents. So good luck. I think you have added a very special perspective here.

Senator Levin.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you, Mr. Chairman. We are a very young country compared to the ancient countries of Eastern Europe, but now we are the veterans and they are the rookies. When it comes to economic development and free market, we know how to do what they want to learn to do. And I must tell you I just do not feel that we as a Government are encouraging our people to latch onto those opportunities. We get lots of complaints, lots of frustrations. We do not see a massive effort here, like those I see being undertaken in other countries, especially by our allies.

I was recently in Czechoslovakia and East Germany. I can tell you the West Germans and the French and the Brits and the rest of our allies are all over the place, involved deeply, thriving, on the move, excited about the opportunities.

Here I just see a lot of hurdles. I do not see a great momentum toward helping our small business people. They do not need encouragement; they are raring to go, I think. But they have got to be given some help to overcome all of the hurdles and the redtape and the bureaucracy that exists. I do not see that they are getting that help.

When you meet with Polish leadership, and I have met with Lech Walesa a number of times, he says, we want you here, we want you at the economic grassroots. We want your small businesses. We want the joint ventures. We want the investments. We want you here. The same with the Czech leadership.

And yet, I just do not feel as though our agencies are really saying to our small businesses, OK, you are raring to go, because you have got incentives and the know-how, here is how you can do it.

Mr. Duesterberg in a later witness' testimony, he suggests that a number of markets in high technology goods will be throttled if U.S. regulations on exports of technology are not altered. Are those regulations being altered now in light of the fact that there are no longer threatening enemies of ours in Czechoslovakia and East Germany and Poland, but are new allies of ours?

Mr. **DUESTERBERG**. The short answer to that question is yes, they are. We are working as hard and as fast as we can with our counterparts at the State Department and the Department of Defense, and with our allies in COCOM. We have some very specific proposals on the table to streamline procedures, to shorten the list of items that are proscribed, to broaden that list quite a bit.

Senator **LEVIN**. What kind of time table do we have for really moving in that area?

Mr. **DUESTERBERG**. Well, I think it is fairly quick. I mean, the next few months. I am quite confident we can reach agreement.

Mr. **MCALLISTER**. There will be a COCOM meeting in June, and the United States has proposed this idea of differentiating, giving special treatment for the Eastern Europeans. At the last meeting in February, we reduced the licensing period from 12 to 8 weeks. We are also looking at setting up special working groups to look at telecommunications, computers and machine tools, using the China Green Line as a reference point.

We are very aggressively trying to respond to the situation and adapt to it, and permit U.S. business to export more high technology products to Eastern Europe.

Senator **LEVIN**. It is mighty slow compared to other countries.

Mr. **MCALLISTER**. Well, this is all being done in COCOM with our COCOM partners.

Senator **LEVIN**. I have been there, and I can just tell you other countries' businesses are all over the place. I have been to Czechoslovakia and East Germany. They are there.

How do you promote the programs that you mentioned in your testimony? For instance, have you compiled a catalogue of Government programs and services that are available to assist U.S. businesses in taking advantage of the new free enterprise economies in Eastern Europe? Has the Commerce Department done that?

Mr. **DUESTERBERG**. We have a number of fact sheets and brochures that are available to the public, which list that sort of thing.

Senator **LEVIN**. But is there a catalogue of programs like you have done for the Soviet Union?

Mr. **DUESTERBERG**. Let me ask my staff.

Senator **LEVIN**. You have something called Joint Ventures in the Soviet Union. Do we have a guide to joint ventures in Eastern Europe?

Mr. **DUESTERBERG**. Only for Poland and Hungary at this point in time. We are working on the others.

Senator **LEVIN**. What kind of time table?

Mr. **DUESTERBERG**. We should be able to get those done in the next month.

Senator LEVIN. What does a small exporter in Michigan do when he or she wants to export to Eastern Europe? Where do they go?

Mr. DUESTERBERG. They go to the district office of the Foreign Commercial Service.

Senator LEVIN. Is there one place they can go to get all the answers they need? Do they go to the Small Business Administration or the Department of Commerce or to the Trade Representative? Where do they go?

Mr. DUESTERBERG. We do cooperate quite a bit with the Small Business Administration. We develop data bases in conjunction with the Small Business Administration.

Senator LEVIN. Should they go to the SBA office or should they go to your office?

Mr. DUESTERBERG. The first place they should go is to the Foreign Commercial Service office if they are interested in purely and simply exporting. They need to learn about the business conditions in the country they want to go to, and they need to learn about the market that they would like to enter. And if they are convinced that it is a good opportunity for them, then they need to go over there. And we can put them in touch with our staff abroad.

Senator LEVIN. Mr. McAllister, on the normalization of trade with the Soviet Union issue, is that going to be raised at the summit in June? Do you expect that whether or not they formalize their new procedures relative to emigration in their laws, that we will have a period of—or at least a trial period of normal trade with the Soviet Union, giving them most favored nation status for a couple of years?

Mr. MCALLISTER. The President has said he wants a trade agreement done by June, so that we can permit them MFN status, provided that they enact the emigration legislation.

Senator LEVIN. That is still a sticking point, even though they are letting out mass numbers of people now, more than we're willing to accept. Is that still going to remain a sticking point?

Mr. MCALLISTER. In our discussions with the Soviets it does not appear to be a sticking point because we have been assured that that legislation will be enacted before June.

Senator LEVIN. How recently were you told that?

Mr. MCALLISTER. The Secretary's recent visit to the Soviet Union, which was February.

Senator LEVIN. My time is up. Thank you.

Senator LIEBERMAN. Thank you, Senator Levin.

I thank the panel. There are more questions I would like to ask, but time compels us to move on. We will submit some written questions to you. One of the later witnesses makes a very strong case for greater support of the Ex-Im Bank than is provided for in the Administration's budget. The bank is particularly important to help American businesses export to Eastern Europe. The witness also notes that the Japanese are moving in that direction very aggressively. I am sorry I don't have the time to pursue this with you now.

I again thank you for your testimony and hope you leave here with a few thoughts. I think the feeling on this side is that we are moving in the right direction, although we probably would like you to move more quickly, more aggressively, In addition, you should do whatever you can to make greater use of the American private sector, which is so eager to help. Finally, I hope you will consider us your allies because we do want to be of whatever help we can, particularly in trying to help American small business get involved productively in the markets of Eastern Europe.

I thank you.

Senator **Levin**. Before they leave, Mr. Chairman, could I just confirm what you just said about our being their allies. There are times when witnesses will come in here and there will be real differences in terms of what we want to be doing. I have got to tell you I think that this Congress is where I think you folks are, or at least where you want to go. If it looks like we are prodding you faster than you want to be prodded, it is only because I think we share the same frustration. There are great opportunities out there. I think you folks see it. We see it. We want to be helpful. The American people and the business community are just anxious to get going. Let us know how we can be helpful.

Senator **Lieberman**. Thank you.

I will call a second panel now. While they are coming up, on Senator Kasten's behalf, I will enter into the record the column by David Broder, which he mentioned.

[Material follows:]

Washington Post, 3/21/90

David S. Broder

What's Polish Democracy Worth?

Two officials of the Solidarity-led Polish government are in Washington this week. One, Prime Minister Tadeusz Mazowiecki, is being toasted and welcomed at the White House and on Capitol Hill. Eager officials are urging him to voice his views on German unification and other weighty matters.

The other, Wiktor Kulerski, the first deputy minister of national education, is having a harder time getting anyone's attention for his plea for help in reviving Poland's schools. Seeking to reorient his nation from the Communist ideology of the past 45 years to an understanding of democracy and a free-market economy, this veteran of the 10-year underground struggle is finding Washington preoccupied with other things.

The contrast tells a lot about where we are in supporting the movement toward freedom in Eastern Europe: Our goodwill is running ahead of our good deeds.

No question that the American people and government have given their hearts to the new leaders who freed their lands from Soviet domination. Lech Walesa and Vaclav Havel have provided more inspiration to Washington than any other visitors in years.

But when the cheering stops, those men and women face daunting challenges against which America's talent and resources might make a critical difference. We are not turning our backs on them, but we are not yet geared up to help as we should be.

Here's an example. Although President Bush has spoken with some eloquence at least three times on the importance of voluntary efforts to aid the Eastern Europeans, the forums—a late-night speech to a Los Angeles business group, for example—guaranteed minimal coverage. Even today, no one on the White House staff has been designated as the president's personal representative on this project. There's no one rallying support for Eastern Europe the way Oliver North evangelized, with President Reagan's blessing, for aid to the contras.

Several months ago, Bush designated Deputy Secretary of State Lawrence S. Eagleburger as the coordinator of administration efforts in Eastern Europe. Eagleburger is an able, experienced operative with much too much to do—including managing the whole State Department on the frequent occasions when Secretary of State James Baker is traveling.

His staff for the Eastern European project consists of two enormously overworked people called back from assignments in Ottawa and trying to coordinate the work of some 20 separate government agencies.

In a speech last week, Eagleburger argued forcefully—and I think persuasively—that institution-building must precede massive infusions of outside economic aid in these countries. They must have the capacity to use the money, he said, or it will be wasted.

Some good things are being done with American assistance to build those basic democratic and capitalist institutions. From the $300 million Poland-Hungary assistance package Congress voted last November, the Agency for International Development gave $10 million to the National Endowment for Democracy to help prepare the emerging parties and leaders for the round of free elections just beginning in Eastern Europe. NED has plans to expand its operations to help parties, unions, student groups and publications in Romania, Bulgaria, Czechoslovakia and Yugoslavia. But Carl Gershman, its president, says: "There is such a hunger . . . and our budget allows us just to do the bare minimum."

Private organizations are helping. The Chamber of Commerce of the United States, which had programs in Eastern Europe as far back as the 1970s, has just established a regional trade and technical center to serve budding entrepreneurs and help the new governments establish market-oriented economic policies. The American Bar Association has approved plans for an institute on law reform with a library and experts available to help the Eastern Europeans rewrite their laws.

The International Executive Service Corps, a 26-year-old group, has recruited two retired executives as short-term advisers to Polish rayon and TV-tube factories.

It's all commendable, but somehow it doesn't begin to measure up to the need—or the opportunity. These countries, for example, are desperate to get translated copies of the Declaration of Independence into their schools and libraries so their people can discuss the concept of human rights.

Which brings me back to Wiktor Kulerski. He came to Washington under the auspices of the American Federation of Teachers, which sent two teachers to Poland earlier this year to conduct week-long seminars for some 50 Polish teachers on "education in democracy." Another slightly larger group is going over this summer for a month.

But Poland, Kulerski says, has 7 million students who know little of democracy and less of the English language. It has 18,000 Russian-language teachers and fewer than 1,000 equipped to teach English.

"We need 20,000 English-language teachers," he said, "and we have no way of training them ourselves." On his visit, Kulerski said, he confirmed that the Peace Corps in June will send 60 English teachers to Poland as it starts operations in that country.

Like almost everything else we're doing, that's fine. But it's not enough.

Senator LIEBERMAN. This panel is composed of Frank Doyle, Eugene Madara, Joseph Bell, and Peter von Braun. These are the folks we have been talking about. These are the folks in American business who have been over there, who have a story to tell, who have some counsel to give.

And I must say, to the four of you as you are approaching the table, I talked earlier about the quality of the written testimony. I thought the testimony that you you provided was really outstanding and would be of tremendous value to any business person in this country thinking about going into business in Eastern Europe or the Soviet Union.

Generally speaking, we want to hear about your experiences. We would like to hear your evaluation of what the opportunities are for American business in Eastern Europe and the Soviet Union, and of course, what can we in the Federal Government do to support that activity.

We are running a little later than we had planned, so if you can keep a closer eye on those lights, we would appreciate it. And then Senator Levin and I will try to enter into a discussion with you.

First I am going to call on Frank Doyle, who is the senior vice president of General Electric, which I cannot control myself from noting is headquartered in Fairfield.

Thank you for being here, Mr. Doyle.

STATEMENT OF FRANK P. DOYLE, SENIOR VICE PRESIDENT, GENERAL ELECTRIC

Mr. DOYLE. Thank you, Senator. Thank you for inviting me. It is not often that GE is invited to testify at a Small Business Committee hearing. I think however, I can make the case that there is a very good reason for us being here.

GE, of course, has been very interested in participating in the liberalizing nations' economies of Central Europe, both as an investor in and as an exporter to these economies.

Our investment in Tungsram of Hungary, announced the very week the Berlin Wall fell, was especially exciting for us. We have a majority position there. We think we can bring some management expertise and investments to help this really fine and renowned company become a stronger contributor to the Hungarian economy and also be good business for us.

We also have participated in Czechoslovakia in the aircraft engine business. We are contracted to supply some $300 million in turbo prop engines for the Czech commuter aircraft being developed for world markets. And, obviously, we hope to expand into other areas in Central and Eastern Europe and in other product lines, both in aircraft engines, power equipment, and other infrastructure kinds of equipment.

It is in the second area, however, that of an export opportunity for both large and small U.S. companies, that I want to make the main focus of what I say today. As you know we have submitted a longer paper on that, but let me touch a few highlights.

There is a real need, and I think that what is being discussed here this morning is complementary to the initiatives in SEED II legislation currently moving through the House and Senate. I think small business should have a particular interest in simplifying the OPIC insurance application process. When we made our investment in Tungsram, that was swiftly moved on. It was an important factor for us. But it is a complex process, and I think small business really does need help, and I suggest that that legislation should certainly include that.

I think the language in your own legislation, Senator, to increase the number of commercial and economic officers in the region could help provide access to smaller business. It is not an easy market to penetrate. It is hard to understand how they do business there. And unless you have a greater number of resources, as some large companies do, it is extremely difficult to become a factor.

We think the rebuilding of these economies is going to be one of the exciting opportunities, both in terms of the society as a whole, but also economically. Who satisfies those needs may well determine trading patterns, not only in the short term but for decades to come.

There is a real need in these markets. There is the infrastructure condition of the nation has been eroding for 40 years, and typically we are positioned well to satisfy those needs. But these liberalizing nations have a very dire need and a tough problem. They have no hard currency, and without hard currency, they are very dependent on credit. And until they can make those economies competitive, they are going to be dependent upon not only good products, but also financing packages for any of the big-ticket capital goods items that they want to buy.

And I think these linkages between capacity and credit are known to our competitors and to their governments, and that is why many of the new Japanese and Western European aid packages to Central and Eastern Europe speak directly to that issue. Japan's $.5 billion commitment to Hungary will be in the form of guarantees and credits that can be tied to purchases from Japanese suppliers. More than two-thirds of the $1 billion European investment bank commitment to Poland and Hungary over the next 3 years will take a similar form.

Senator LIEBERMAN. So this is not just a case of the Japanese and the West Europeans offering assistance to the nations of Eastern Europe and walking away. That aid is tied quite directly to expected commercial relations.

Mr. DOYLE. I think the commercial relationships, Senator, are going to be absolutely tied to that kind of transaction, and that is the need is going to be there; people will want to buy. Ideally, we would like them to find the lowest cost and the best quality anywhere in the world. But without credit, they simply are going to be unable to buy. And the tie breaker, or maybe even more than the tie breaker, is going to be the availability of credit. And I think in that particular area the United States is going to be disadvantaged, certainly under the current discussions on Ex-Im Bank financing.

Senator LIEBERMAN. In other words, whichever country can provide credit to the Eastern European country in a business transaction will get the contract?

Mr. DOYLE. I think it is inevitable. As you know, the current administration proposal for $500 million of Ex-Im financing spread across the entire world is just far short of what anyone else is going to be doing, and far short of what the needs are.

We look at market after market, either in Central Europe or in the USSR, and we can forecast multi-billion dollar market needs and hard currency capacity of one-tenth of what their market needs are going to be.

And as a consequence, they will never get on track unless they fix the infrastructure problems, the transportation and power needs. And until they do that, they are not going to be participating in the world economy in a meaningful way.

Senator LIEBERMAN. That is a very strong point, both in terms of the Ex-Im Bank and how we are effectively going to business.

I think it also directs us—I am cutting into your time so I will let you talk some more, but it also makes the point that is so critical at this time, as we argue about foreign aid packages, that a lot of the foreign aid they were talking about to Eastern Europe is not, as I just said the classic sort of write a check and walk away. It is going to be critical to American business success there, and in that sense, a lot of it, as other foreign aid, is going to turn around and come back to us. Foreign aid is never popular, but it is important to foreign aid for us to try to educate the American people about the importance as an extension of our American economic program.

Mr. DOYLE. I would make two points on that Senator. One is that we really do think that the Ex-Im Bank financing must be increased, and Ex-Im Bank financing is going to determine where the trade and where the orders are placed.

Second, one of the problems with Ex-Im Bank financing is that it is often misunderstood with regard to it being a large company benefit. When we look to the way that we manufacture goods, and I think there are just two GE examples, which are I think repeated everywhere in our economy. Fully 65 percent of the manufacturing content of a GE jet engine, one of our most successful export products, is supplied by subcontractors. And small business accounts for about 43 percent of that total volume.

In power, it is even more dramatic. Our gas turbines are 83 percent in the hands of subcontractors, and a very substantial portion of that is tied to small businesses. Small businesses are going to have an extremely difficult time going directly into these complex economies, particularly since the need is for infrastructure development. But they are very meaningful participants in international trade through the large global reach companies. And that is why I think that we can make a strong case for Ex-Im Bank financing increases. And I am glad to be able to make it here at the Small Business Committee.

[The prepared statement of Mr. Doyle follows:]

FOR RELEASE ON
FRIDAY, MARCH 23, 1990

Testimony of Frank P. Doyle

Senior Vice President, General Electric

U.S. Senate Small Business Committee

Hearing on U.S. Trade and Economic Relations
With Eastern Europe and the Soviet Union

Washington, D.C.
March 23, 1990

Thank you for inviting me to testify this morning. It is not often that a GE executive is invited to testify before the Small Business Committee. So this is a novel experience for which I am grateful.

There is an important connection, however, between a large American company like GE and export opportunities for small businesses. GE is an export channel for hundreds of small companies who are subcontractors on major capital goods such as turbines and aircraft engines. This relationship is one to which I will return in a few minutes.

But first let me establish why GE has an interest in the newly liberalizing nations of Central and Eastern Europe. Our interest is two-fold, as an investor in-- and as an exporter to-- these economies.

Our investment in Tungsram of Hungary, announced the week after the Berlin Wall fell last November, is especially exciting for GE. We bought a 50% plus one share majority interest in that long-established and highly regarded lighting company. Through the management expertise we bring and the investments we plan to make in Tungsram's process and product technology, we expect to contribute significantly both to Hungary's economic development and to GE's overall competitive position in the global lighting market. To run the business, we appointed an American named George Varga. Varga is not only a seasoned GE executive but a native Hungarian who left in 1956, when he was a high school student in Budapest.

In late January of 1990 we also announced an agreement with a Czech aircraft engine firm (LET) to supply up to $300 million of turboprop engines for a Czech commuter aircraft being developed for world markets. We are continuing to assess going concerns in the region for similar investments or joint ventures in other product markets that we serve.

We also hope to expand exports to Central and Eastern European nations. Our greatest success in the region to date has been with our aircraft engines business, which has already won orders from the national carriers of East Germany, Poland and Czechoslovakia, with others pending. Expected demand for modernizing the infrastructure of these countries also may provide export opportunities for other GE businesses, especially our industrial and power systems group.

It is the second arena-- the export opportunity both for large and smaller U.S. companies-- that I want to make the focus of my testimony this morning. I also am submitting for the record a longer paper that addresses the export finance issue, along with proposals to encourage and ease U.S. direct investment in the region. Many of our proposals are consistent with-- or complementary to-- provisions contained in the "SEED II" legislation currently moving through the Senate and the House.

Of particular interest to small business, our paper recommends simplifying the OPIC insurance application process for smaller U.S. firms. Attaining OPIC insurance was essential to the GE/Tungsram deal, and it's a great credit to OPIC and other Executive branch agencies that they were able to act as quickly as they did. The expansion of OPIC coverage to other SEED II countries-- especially to the extent that it is made more accessible to smaller firms-- will provide indispensable confidence for prospective U.S. investors.

The legislation just introduced by Senator Lieberman also contains several very constructive proposals for assisting U.S. small business in Central and Eastern Europe. The proposal to increase the number of commercial and economic officers in the region could help provide greater access for smaller companies. The foundation envisioned in the bill could become a vital tool for small and mid-sized businesses and entrepreneurs as opportunities expand in these emerging markets.

The rebuilding of the economies of Central and Eastern Europe will be one of the great economic dramas of the late 20th and early 21st centuries. Infrastructure is hardly the stuff of poetry, but the building of power plants and highways east of the Elbe in the Nineties may become the stuff of epic. At stake will be jobs, trade patterns and living standards, East and West.

These opportunities for American companies are potentially enormous, extending from the simplest consumer to the most complex capital goods. Economic liberalization was mostly responsible for the 13% increase in the East Bloc's import volume last year, almost entirely run up before the democratic upheavals of November and December. Although economists argue over how much and how quickly trade will expand this year and next, it seems certain that the process will continue to accelerate.

These liberalizing nations have a dire need, but also a tough problem: no hard currency. Without hard currency, they are dependent on credit. Until they can make their economies and companies competitive, financing packages for big-ticket capital goods may prove decisive in winning major orders.

These simple linkages are obvious to our competitors and their governments. That's why much of the new Japanese and Western European aid to Central and Eastern Europe announced over the past several months is in concessionary trade financing. Virtually all of Japan's half-billion dollar commitment to Hungary will come in the form of guarantees and credits that could be tied to purchases from Japanese suppliers. More than two-thirds of the $1 billion European Investment Bank commitment to Poland and Hungary over the next three years will take a similar form.

Although Japanese trade with Central and Eastern Europe has been relatively small to date, the new interest on the part of Japanese companies is being reinforced by pledges of substantial government assistance. Prime Minister Kaifu recently announced a combined credit and aid package that includes:

- $500 million of Export-Import Bank credits each for Poland and Hungary.
- $350 million in trade insurance to cover Polish imports from Japan.
- $200 million in new trade insurance for exports to Hungary.
- $25 million for technical cooperation with Poland and Hungary.

In the short term, this likely imbalance in trade finance assistance could mean fewer American export orders and greater initial Western European and Japanese penetration of developing Central and Eastern European markets. In the long term, it may mean the setting of patterns of trade and investment for the next decade, perhaps even for the next half-century.

We won't win many orders without the best products at the best quality and the best price. But without competitive financing, we won't win any orders at all.

The Administration is proposing to cut Ex-Im FY'91 direct lending authority to $500 million exactly at a time when U.S export opportunities are increasing not only in Central and Eastern Europe but in the Asian countries where Japanese competition is severe and in Latin America where economies are beginning to recover.

Ex-Im's direct lending authority of $612 million last year pales into virtual unilateral disarmament when compared not only to these growing export opportunities but also to the aggressive concessionary trade finance mechanisms maintained by Japan and several of the European nations.

A substantial boost right now in Ex-Im funding amounts to a long-term investment that the U.S. may not get another chance to make. A serious effort to match the challenge would require doubling the Administration's FY'91 Ex-Im direct loan proposal of $500 million to $1 billion.

Such additional funding (above the Administration's request) should be authorized in a manner that Ex-Im would be strongly encouraged to expand lending programs for the Central and Eastern European nations. Legislative language-- along the lines of Senator Lieberman's bill-- could make clear "the Sense of the Congress" that greater support should be dedicated to Central and Eastern Europe. This approach has the advantage of allowing the Bank to meet increased demand on its direct loan program while retaining the flexibility that might be lost through specific earmarking.

On top of this additional direct loan authority for Ex-Im, a stand-by credit facility should be established to meet foreign mixed credit or tied aid offerings. At present a so-called War Chest-- funded at $300 million-- is in place for use around the world. An additional $200 million should be authorized, with the informal understanding that it is being added to match the European and Japanese mixed credit packages for Central and Eastern Europe. The facility could be terminated by the President on a determination that effective discipline has been achieved so that U.S. exporters are no longer competitively disadvantaged.

Adding funds to the War Chest will help the U.S. government increase its leverage in the forthcoming OECD negotiations on tied aid in order to curtail these uneconomic, distorting subsidies. It will also help U.S. companies stay competitive in Central and Eastern Europe.

Unfortunately, this is an issue over which we probably must prepare to play poker in order to call off the game.

Even these proposals for beefing up both the War Chest and Ex-Im direct loan authority would leave the Japanese and Europeans potentially offering concessionary export assistance at levels far above the U.S. level. It is important to recall, when considering raising direct loan authority to $1 billion, that the program has suffered a catastrophic erosion in funding from its peak of $5.4 billion in FY'81.

It is at least as important to recall why those deep cuts were made and why they were politically acceptable to those who made them. The explanation involves much more than the slowdown in global trade in the early Eighties or the fundamental budget pressures that continue to constrain us.

I will offer the unexpected view that there was some justification for cutting Ex-Im direct loan authority from its 1981 peak. U.S. producers of capital goods were not as cost-competitive as we should have been then or are now; to that extent, some Ex-Im loans probably in effect subsidized some inefficient producers.

But American industry regained its cost-competitiveness through the wrenching, even agonizing restructuring process of the Eighties. We cut costs, refocused our businesses, invested in plant and equipment and raised productivity. Productivity growth in U.S. manufacturing at the end of the Eighties is more than twice what it was at the beginning of the decade. At GE, annual productivity growth rose from the 1-2% range in the early Eighties to nearly the 6% level as we enter the Nineties.

Let me be blunt: U.S. industry is now doing its part on cost competitiveness. Now it's time for the U.S. government to do its part to help us compete on a level playing field with our Western European and Japanese competitors.

I think another set of facts should transform the way Ex-Im is viewed. We're all aware of the lingering perception that the Bank is a big company benefit. Of course large companies use Ex-Im facilities. But there also is a less well-known small business constituency at the heart of the Bank's mission that can be seen in two ways.

First, companies that meet the SBA's definition of "medium-to-small" account for fully 30% of Ex-Im's transactions to date in the current fiscal year. There is direct access to the Bank's facilities for small business, though that access should be further expanded and simplified.

Second, smaller companies participate in export markets-- and indirectly in Ex-Im financing-- through the large companies that have the resources and reach to sell big ticket capital goods overseas. They participate through us as sub-contractors, in many cases supplying a majority of the content of completed goods that big companies sell and ship.

Two GE examples demonstrate our export relationship with small business:

- Some 65% of the manufacturing content of a GE jet engine-- parts worth 45% of its sales volume-- is supplied by sub-contractors. Small businesses helped our Aircraft Engines business account for the largest part of GE's $4.8 billion positive contribution to the U.S. balance of trade in 1989.

- The other GE example is from our industrial and power systems business. Some 83% of the average material cost of a MS9001 gas turbine is supplied by domestic sub-contractors to GE. For a typical large steam generator unit, 67% of the average material costs are sub-contracted. Both gas and steam turbine sales have received Ex-Im support, allowing smaller companies to export through us.

The Ex-Im Bank now has the chance to be of even greater assistance to American businesses-- small and large alike-- if it receives the resources it needs to make a difference in the real competitive world.

The dramatic changes in Central and Eastern Europe will and should be of greatest benefit to those emerging democracies themselves. Trade and investment links to the West-- not just back across the Elbe but across the Atlantic-- should also be part of their reintegration in the free world. The Congress and the Administration have a rare, historic chance right now to seize that opportunity for the benefit of us all.

SUPPLEMENTING U.S. AID TO CENTRAL AND EASTERN EUROPE: Summary Proposals

U.S. economic policy toward the newly liberalizing nations of Central and Eastern Europe should advance two mutually-reinforcing goals. First, we should support movement toward free market economies to complement the creation of free democratic institutions. Second, U.S. investment should be promoted, with the corollary objectives of boosting U.S. exports and remaining competitive with government-supported Western European and Japanese companies in the region.

Summary recommendations for additional U.S. assistance are:

- Restore U.S. competitiveness in export finance at a time when export opportunities are expanding, more nations are gaining Ex-Im eligibility, and EC governments and Japan are targeting concessionary trade financing to Eastern Europe.

-- Double the Administration's proposed FY'91 Ex-Im direct loan authority request from $500M to $1B.

-- Add $200M to the $300M war chest in place to meet the challenge of foreign mixed credit or tied aid offerings, while negotiating to end such distorting subsidies.

- Expand OPIC direct loan and investment guarantee programs in Central and Eastern Europe, and streamline the OPIC application process to benefit smaller firms.

- Assure that the evolving economic relationships between the Central and Eastern European nations and established market economies are built on free trade and open investment by securing market access for a fair share of Central and Eastern European exports to the U.S., the EC and Japan. As economic reform progresses, certain countries should be "graduated" from their status as state-trading (non-market) economies so as to eliminate or phase-out disadvantages they suffer under GATT rules such as the anti-dumping code.

- Work within Cocom to more quickly and comprehensively relax export control restrictions without jeopardizing security.

- Expand management training and technical assistance by:

-- Funding American experts to advise on the writing of basic financial, banking and other economic regulations, and retired executive volunteers to advise on managing business.

-- Further supplementing labor training by the Department of Labor and providing U.S. labor-management expertise on adjustment for displaced workers in a free labor market.

-- Playing a more active role in G-24 multilateral assistance in areas such as environmental protection.

- Support the establishment and substantial capitalization of a European Bank for Reconstruction and Development, with an initial U.S. contribution of at least $250M.

- Assist investors seeking to repatriate profits-- and help Central and Eastern European nations expand trade beyond the Eastern bloc-- by helping establish a multilateral revolving fund in the absence of convertible currencies.

PROPOSALS FOR SUPPLEMENTING U.S AID TO CENTRAL AND EASTERN EUROPE

Following are recommendations for additional U.S. assistance beyond the SEED legislation enacted last November:

Export Finance

The Administration is proposing to cut Ex-Im FY'91 direct lending authority to $500M exactly at a time when U.S export opportunities are increasing not only in Central and Eastern Europe, but in the Asian countries where Japanese competition is severe and in Latin America where economies are beginning to recover.

Already the direct loan program is overcommitted with projects in the pipeline. Moreover, it is clear that there will be substantial new demand for Ex-Im support, with eligibility newly approved or likely to be negotiated by the end of this year for Panama, Yugoslavia, Hungary, Czechoslovakia, Poland, Bulgaria, Romania, China and the USSR (with the expected end of Jackson-Vanik restrictions.)

Ex-Im's direct lending authority of $612M last year pales into virtual unilateral disarmament when compared not only to these growing export opportunities, but to the aggressive concessionary trade finance war chests maintained by Japan and several of the Western European nations.

Moreover, much of the new Japanese and Western European aid to Central and Eastern Europe just announced over the past several months is in concessionary trade financing. Virtually all of Japan's half-billion commitment to Hungary will come in the form of guarantees and credits that could be tied to purchases from Japanese suppliers. More than two-thirds of the $1B European Investment Bank commitment to Poland and Hungary over the next three years will take a similar form.

Although Japanese trade with Central and Eastern Europe has been relatively small and doubts persist about investment prospects, there is new interest on the part of Japanese companies (as demonstrated by the proposed Suzuki investment in Hungary) that is being reinforced by pledges of substantial government assistance. Prime Minister Kaifu announced on his recent trip to Eastern Europe a combined credit and aid package including:

- $500M of Export-Import Bank credits each for Poland and Hungary.
- $350M in trade insurance to cover Polish imports from Japan.
- $200M in new trade insurance for exports to Hungary.
- $25M for technical cooperation with Poland and Hungary.

In the short term, this likely imbalance in trade finance assistance could mean fewer American export orders and greater initial Western European and Japanese penetration of developing

Central and Eastern European markets. In the long term, it may mean the setting of patterns of trade and investment for the next decade, perhaps even for the next half century.

A substantial boost right now in Ex-Im funding amounts to a long term investment that the U.S. may not get another chance to make. A serious effort to match the challenge would require doubling the Administration's FY'91 Ex-Im direct loan proposal of $500M to $1B.

An alternative means of achieving the $1B would be to increase the the Administration's $500M request by 50% to $750M, and then applying an operational IEP (Interest Equalization Program) appropriation of $25M. This alternative, as currently proposed by the business-labor Coalition for Employment Through Exports, Inc. (CEE), rests on the assumption that a $25M interest subsidy has a 10:1 leveraging factor, therefore amounting to $250M. (IEP effectively compensates the commercial bank for the difference between the commercial rate and the OECD rate.)

Such additional funding (above the Administration's request) should be authorized in a manner that Ex-Im would be strongly encouraged to expand lending programs for the Central and Eastern European nations. Committee language could make clear the sense of the Congress that greater support should be dedicated to Central and Eastern Europe. This approach has the advantage of allowing the Bank to meet increased demand on its direct loan program while retaining the flexibility that might be lost through specific earmarking.

Even this proposal would leave the Japanese and Western Europeans potentially offering concessional export assistance at levels far above the U.S. It is important to recall when considering raising direct loan authority to $1B that the program has suffered a catastrophic erosion in funding from its peak of $5.4B in FY'81.

On top of this additional direct loan authority for Ex-Im, a stand-by credit facility should be established to meet foreign mixed credit or tied aid offerings. At present such a war chest-- funded at $300M-- is in place for use around the world. An additional $200M should be authorized, with the informal understanding that it is being added to match the European and Japanese mixed credit packages for Central and Eastern Europe. The facility could be terminated by the President on a determination that effective discipline has been achieved so that U.S. exporters are no longer competitively disadvantaged. Creating an effective mixed credit program would require allocating substantial additional resources to AID and changes in AID's current thrust toward more support for capital projects.

But adding to the war chest will help the U.S. government increase its leverage in the forthcoming OECD negotiations on tied aid in order to curtail these uneconomic, distorting subsidies. It will also help U.S. companies stay competitive in emerging markets. Unfortunately, this is an issue over which we probably must prepare to play poker in order to call off the game.

Ex-Im also needs modest additional funds to hire additional trained project experts (with engineering degrees or MBAs) to evaluate project risks, as well as to relax current stiff restrictions on staff travel. At present, Ex-Im loan officers are evaluating commercial risks based almost entirely on written applications. Additional funds for these twin purposes- probably in the $5M range-- could help Ex-Im more effectively target its loans and guarantees.

Finally, we should continue the process of broadening Ex-Im eligibility. Building on Secretary Baker's constructive recent announcement of Czech eligibility for Ex-Im lending, eligibility should also be reinstated for Romania and extended to East Germany and Bulgaria. But, once again, Ex-Im will need greater resources to meet these greater demands.

OPIC

In addition to expanding Ex-Im's resources, we should utilize other tools available to enhance U.S. competitiveness in Eastern Europe. Beyond Secretary Baker's February 6th pledge in Prague for Czech eligibility for OPIC programs, OPIC's authority should be expanded to cover other countries, particularly Czechoslovakia, Romania, East Germany and Bulgaria, and its resources should be augmented accordingly. Demand for OPIC's direct loan and investment guarantee programs in Central and Eastern Europe is already exceeding current funding levels and will likely grow substantially through 1990 as U.S. investments increase.

OPIC's pilot equity program, section 234(g) (2) of the Foreign Assistance Act of 1961, currently limited to Subsaharan Africa and the Caribbean, should be fully funded and expanded to cover Eastern Europe, and its flexible "special projects" authority -- 22 U.S.C. S2194(e) -- should be funded and directed toward Central and Eastern European projects. Such funds can be used to assist U.S. companies competing for projects in Eastern Europe against subsidized financing packages available from other countries. Giving OPIC a significant role in the mixed credit process could also help energize AID to become more aggressive in utilizing its resources in cooperation with OPIC and Ex-Im.

OPIC seems to have a problem with visibility and access, especially with smaller firms. OPIC itself recognizes this problem, and has recently upgraded its communication and outreach efforts in the small business community. Still, the perception lingers that insurance applications are lengthy and complex, and therefore are bureaucratically beyond the means of small firms that must make and execute investment decisions quickly. OPIC should receive modest further budget allocations for improving outreach and streamlining application processes.

Attaining OPIC insurance was essential to the GE/Tungsram deal. The expansion of OPIC involvement in Central and Eastern Europe-- especially to the extent that it is made more accessible to smaller firms-- will provide indispensable confidence for prospective U.S. investors.

Market Access for Eastern European Nations

It is critical that U.S.-Eastern European trade and investment move both ways. Not only are hard currency-earning exports crucial to economic development, but real (or perceived) trade barriers to Central and Eastern European goods raise the risk of political backlash against Western investment. Although there are few quality goods currently attractive and available to U.S. buyers, that should change quickly as Western investment aid, management assistance and technical training make some initial progress.

As economic reform progress within Poland, Hungary, Romania, Czechoslavkia, these countries should be "graduated" from their status as "state-trading" (non-market) economies. This will reward their efforts by eliminating or phasing out the disadvantages they suffer under such GATT rules as the anti-dumping codes.

As Central and Eastern Europeans make difficult strides towards multi-party democracy and the open global economy, we should be quick to encourage exports from-- as well as to-- those nations. The U.S. should accept its fair share of imports, and work just as quickly to assure the same on the part of the EC and Japan.

Export Controls

The Bush Administration's recent decision to relax certain export controls (on precision machine tools, 32K microprocessors and some telecommunications equipment) is a step in the right direction. So too was U.S. participation in the February 14-15 Cocom comprehensive review of current restrictions. But the U.S. runs the risk of being left behind as other Cocom nations press for further loosening of restrictions on industrial products such as higher-speed computers and more sophisticated telecommunications equipment. If these nations are truly expected to enter the global trading system and become competitive, they must be able to buy the building blocks of modern industrial infrastructures. The legislative proposals that are being introduced (including "SEED II") may be useful vehicles for encouraging the Administration to consider areas of further relaxation without jeopardizing national security.

Management Training and Technical Assistance

If wisely targeted and efficiently administered, such assistance could be as helpful to the success of U.S. investment in Central and Eastern European countries as any other form of aid. Investor confidence will sag after the initial euphoria when the depressing reality sets in that these are economies without financial markets, rational accounting systems, realistic pricing or other fundamentals of market economies. Here U.S. expertise can make a difference.

With few additional resources, the U.S. could set up a special endowment to fund American experts-- working with European experts and officials in the newly liberalizing countries-- to advise on the writing of basic financial, banking and other economic regulations. The sooner that specific, dependable legal frameworks are in place, the sooner that rational markets and serious investment will follow.

A constructive element of the Pell/Biden proposed "SEED II" legislation is increased funding (at $5M) for the International Executive Service Corps for retired executive volunteers to advise on enterprise management. Also constructive are provisions for expanded labor training ($5M) by the Department of Labor and an additional $10M in AID technical training.

Building on the programs about to be launched in Poland and Hungary under the auspices of the SEED legislation, the U.S. government could also provide modest additional resources to coordinate pooled training-- both management and technical-- that could be conducted together by several or more American firms in various capitols or in other areas where a critical mass of investors takes shape. That way the U.S. private and public sectors could together make substantive contributions to local management and labor market skills, while at the same time investing in the success of their own ventures.

Another area to apply U.S. expertise is in the functioning of a free labor market. Given the painful restructuring that these nations are beginning-- especially as privatizations, price and currency reforms are set in motion-- unemployment and social pressure will certainly rise. Lessons from the U.S. experience with plant closings, retraining and reemployment of displaced workers can be helpful, especially to the extent that those lessons are suggested in a balanced, non-ideological way that embraces some of the substantive areas of consensus reached by U.S. companies and unions in the Eighties.

The U.S. should also play an activist role in the G-24 multilateral assistance arena (chaired by the European Commission), which currently includes programs ranging from vocational training to environmental protection standards and technologies. In this context, the Pell/Biden "SEED II" legislation helpfully provides for an increase in the EPA environmental assistance program for Central and Eastern Europe from $40M to $60M. That is an especially crucial priority as EC and other multilateral pollution control standards are stiffened and the Eastern European nations continue to slip back.

European Bank for Reconstruction and Development

This proposed bank would provide multilateral support for private sector initiatives in Central and Eastern Europe, although state-owned entities would not be entirely excluded. The French government has taken the lead in creating this institution, with a running argument on capitalization between the French proposal on the high end at $12B and the British on the low end at $6B. The capitalization issue will be likely settled, and the bank formally launched, next month in Paris.

The U.S. should take a leadership role-- not a follow-on or sideline role-- in the creation of the bank. We should push for a high level of capitalization, and immediately embrace the 8.5% share in the bank proposed for the U.S. (equivalent to the commitments expected of the Soviet Union, Japan, Britain, France, West Germany and Italy). The U.S. should make an initial contribution of at least $250M (the amount proposed on January 30 under the auspices of the Senate "SEED II" legislation), with the contribution contingent on a fair sharing of burdens and responsibilities among donors.

The bank's establishment would lead to multilateral support and funding for major infrastructure development projects, potentially benefitting a wide range of U.S. companies. It is not unreasonable to conclude that these potential benefits for U.S. companies will depend in part on strong U.S. support and substantial funding for the bank.

Revolving Fund

Right now only Poland has currency convertibility, and that is only partial. Therefore it is difficult for investors in Central and Eastern European nations to repatriate profits unless they produce goods for export. The lack of convertibility is a critical barrier to smaller prospective investors with fewer resources and necessarily shorter investment horizons than a GE or GM.

A revolving fund, as proposed by Bob Hormats of Goldman Sachs in a recent New York Times op-ed, would assist in the transition to convertible currencies by providing a supply of dollars, marks and other hard currencies on which the countries could draw to settle accounts. As proposed by Hormats, "they would draw down their accounts when they are running deficits and pay the fund back when they have surpluses." A similar "convertibility fund" was proposed earlier this month by the Kiel Economic Research Institute in West Germany.

Such a transition mechanism on the way to convertibility would allow Central and Eastern European nations to expand trade beyond the Eastern bloc, a critical objective if they are to spur growth and raise living standards.

Conditioning Aid on Continuing Reform

Finally, there should be some conditions attached to the assistance we give to Central and Eastern Europe. The process of political and economic reform seems irreversible in East Germany, Poland, Hungary and Czechoslovakia. But the fact is that reform is only now really beginning in these nations, and it is not clear whether or when in the near future a reform course will advance in Yugoslavia, Bulgaria and Romania. The important point is that all economic progress in the region--

whether it's creating market economies, privatizing state enterprises, attracting foreign investment or raising living standards-- depends on continued success by political reformers.

Although the U.S. government has little leverage on political developments in these nations, there is a helpful stance we can take. We can indicate that we are watching the progress of reform, and that we will step up our assistance as we are assured that political and economic progress is continuing. Secretary Baker essentially made this point on his early February trip to the region, and it was a constructive signal. Conditioning U.S. aid on political and economic reform is good foreign policy and good business policy. We should also be prepared to signal that our assistance is contingent on market access for U.S. as well as EC and other foreign companies.

Short-Term Economic Goals

But as critical as foreign aid and investment are, Eastern European governments must take even more fundamental steps themselves in order to sustain their economies in the global marketplace. Such short-term goals include:

- Achieve realistic cost and exchange rates allowing them to export in world markets.
- Diminish inflationary pressure (down from some prevailing rates nearing 50%) by pursuing conservative fiscal policies and wage restraint until their industries gain productivity and more secure export positions in the West.
- Restrict the incurrence of new foreign debt to a level that limits their debt service to a reasonable relationship to export earnings.
- Develop a climate that would encourage the inflow of western capital and direct investment.

These goals are reasonable and attainable. They are consistent with the conditions that international lending agencies set for extending assistance to LDCs and consistent, for example, with the World Bank conditions agreed to by Poland. Steps toward meeting these goals are bound to accelerate the successful integration of these countries into the nexus of free market economies.

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Senator LIEBERMAN. That is a very powerful point. Thank you. Let us go now to Mr. Eugene Madara, vice president and chief counsel of Asea Brown Boveri, formerly Combustion Engineering, and Senator Levin did point out to me, which in all my innocence I did not know, that three of the four of you are headquartered in Connecticut—somehow.

Mr. MADARA. You really did not know that?

Senator LIEBERMAN. I knew you were. I did not put it all together on this panel.

STATEMENT OF EUGENE E. MADARA, VICE PRESIDENT AND CHIEF COUNSEL, ASEA BROWN BOVERI INC., STAMFORD, CT

Mr. MADARA. Good morning, Mr. Chairman. Thank you for inviting me. As this also proves, two competitors can sit next to each other and agree positively absolutely as to how to approach the Soviet Union and Eastern Europe.

My company has a long history in the Soviet Union and Eastern Europe. We were one of the ones who could not wait for Senator Burns' gate to open. We jumped over the wall. We formed the first American joint venture with the Soviets, and additionally the largest one formed to date.

My experiences have been pretty much chiefly based on the Soviet Union, and I would like to address that in particular. I think the point that Mr. Doyle made is correct. Although Asea Brown Boveri is a big company, we are really a funnel through which an awful lot of small businesses can enter Eastern Europe and the Soviet Union, and the problems that big business has in those markets are exactly the same as the little businesses have, and I think that is something that a Small Business Committee ought to note. Let us put together a partnership between big and small businesses to approach these marketplaces.

What we are seeing today is that President Gorbachev is leading his Soviets, kicking and screaming somewhat, into the western industrialized world. He has got an economy in shambles. The ruble is virtually worthless, and barter is one of the principal ways to trade there, and the country is suffering from a prolonged isolation economically.

What is happening in response to his overtures is the major Western Nations—Germany, Italy, England, France, and Japan—are rushing in there to provide financing, training, and investment. All of that is being done as a logical outgrowth of what they have got as a mercantile policy, and America is not really involved.

Why? Well, I think American business suffers from two problems; one is governmental, and the other is the stock market. Now, we can handle the stock market eventually, the problem of shortsighted financial community goals, quarterly accounting—that problem—but the U.S. trade and credit restrictions and the burdensome export control system is something that I think Congress can solve.

We have got to have the legislation and new regulation to work on that, and American business is ready to work with the Congress. Treat us as an asset. We want to work to help find solutions. With all due respect to the previous panel, seminars and additional commercial counselors are not going to help. They can tell you yes, there are opportunities in Eastern Europe and the Soviet Union, but when it comes to yes, but how do I get paid, how do I compete with our major trading partners who have government financing, they do not have the answers for that.

The competitive impact—in 1987, $21 billion of exports were made to the Soviet Union. The American share was $1.5 billion, and two-thirds of that was agricultural, and if we are going to try and compete in those markets with our major trading partners on a commodity, lowest-price basis, we are not going to be able to do it.

In 1987, the Soviet Union imported $6 billion worth of capital equipment. Our share was 2.3 percent, and the lack of American participation is ironic, since the Soviets really prefer to deal with Americans. From long dealing with them, I can tell you they regard us as technological leaders.

They regard us as industrious, as a people, and as honest businessmen, and trade with the United States is very, very important to the Soviets, politically, economically, and most importantly psychologically, because it really means they have been welcomed into the global economy, that they are full and equal partners, and that psychologically is important, but the market is slipping away to the Europeans and the Japanese.

The problem? Threefold. One, America does not have an effective mercantile policy, in contrast to our major trading partners. Second, business and Government in this country coexist without a common objective—in fact, often as adversaries. Government has used business as a foreign policy tool for many years before and after the Afghan War and the gas pipeline boycotts, but it makes us look like unreliable suppliers. We are not trusted because of that.

Third, American business operates alone. We do not have our Government's political and financial backing, and we are always threatened with outdated regulatory schemes that threaten to destroy years of marketing efforts and even contracts that have already been signed. Contract sanctity is not protected. Our major trading partners do not have that problem.

The solution that we see at ADB is that we can only normalize our trade relations with the Soviets and with Eastern Europe if we normalize our trade relations with the U.S. Government, if we form a partnership. A lot of the legislation that has been introduced is the way to do it. The idea that you have submitted about having a development combination of business and Government, work up a national strategy—absolutely right. We need a long-term partnership.

Specific actions will help. We need an effective bilateral trade agreement granted most favored nation status—absolutely important—and a 3-year waiver of Jackson-Vanik. A 1-year waiver as provided by Jackson-Vanik is just too short.

I, as a businessman, cannot plan in terms of 1 year in that market, and the people that are buying will take a look at us as, a 1-year time period means we can shift in American policy again. We are back to the unreliable trader, as compared to the Germans and the Italians and the Japanese and the others, and if the Soviet

Union continues to reform as it is, repeal Jackson-Vanik. It is just getting in the way.

The trade agreement has to address major business problems that affect us—the inconvertibility of the ruble, for instance. There are many problems. But the point we have got to make now, when we are negotiating the trade agreement, that the Soviets have to recognize is look, if you get most favored nation status, that is not going to benefit American companies like ours one iota. It benefits the exporter from the Soviet Union. So you have got to trade something to us to have a little fair play here.

For instance, get them to commit a portion of the hard currency that they earn by exporting to the United States to the purchase of American origin goods. Balance this thing off for a while until trade does normalize.

Telecommunications is a major problem. How about some government-to-government grants that would be provided to the Soviet Union for American telecommunication companies to install the telecommunications systems that are vital? At the moment, communications in the Soviet Union are just atrocious.

Additionally, we need an effective bilateral investment protection treaty. Somehow, the Soviets have got to reduce the risk of Americans going in, large and small business, forming joint ventures, and then being stuck with no guarantee of being able to repay trade profits in hard currency—that sort of thing.

We need an effective tax treaty. One example I will give you is, we had to invest in the Soviet Union through Austria, because there is no dividend withholding tax treaty between Austria and the Soviet Union. We do not have that. That is 20 percent on every dividend. We need to revise our Tax Code to take into account, what are ruble profits worth? Are they income?

Do we get offsetting foreign tax credit for Soviet taxes paid? Nobody knows. And that's the problem. But most importantly, and this is the key, export credit financing is the key to doing business. As Mr. Doyle said, if you cannot find a way to finance the project, somebody else is going to take the project from you. Small business cannot answer the question how do I get paid unless the financing is available.

And American Government—this Government is the only major trading partner in the world that does not provide export financing when dealing with the Soviet Union. We have got to fund Ex-Im Bank effectively and consistently. It cannot be on one year and off the next year. These projects do not work that way.

And we have got to realistically revise the export control legislation. It is coming up for renewal in September. Simply saying carry on as usual is no good. The Government has to realistically recognize that the Soviets are not the military threat that they were and that unless we enable U.S. business, large and small, and small maybe through large business, to do business, the Germans, the Japanese, the British, and the French, who have all gotten there ahead of us, are going to take it away from us.

[The prepared statement of Mr. Madara follows:]

REMARKS OF EUGENE E. MADARA
ASEA BROWN BOVERI INC.
BEFORE THE
SMALL BUSINESS COMMITTEE
UNITED STATES SENATE
WASHINGTON, D.C.
MARCH 23, 1990

Mr. Chairman, Members of the Committee:

My name is Eugene E. Madara and I am Vice President and Chief Counsel of Asea Brown Boveri Inc., a Stamford, Connecticut company that employs about 35,000 people in the United States serving primarily the international power generation and process control industries. I thank you for this opportunity to talk with the Committee regarding United States trade and economic relations with Eastern Europe and the Soviet Union since I believe that it is a topic vital to our national interest and that the United States Senate has an opportunity to take the lead in directing our country's position in the global economy well into the next century.

My company has a long history of doing business in the Soviet Union and was the first American company to form a joint venture there. Most recently, we completed negotiations regarding the largest of such ventures formed to date. We have had extensive discussions with senior Soviet Government officials regarding the development of the Soviet economy. ABB has also been doing business throughout Eastern Europe for many years. My personal experience has chiefly been in dealing with the Soviet Union; therefore, I would like to direct my remarks primarily toward our trade relations with that country.

Two hundred fifty years ago, Peter the Great led his Russians, kicking and screaming, into the Western industrialized world. His economy was in shambles, the Russian ruble was worthless, compelling what little foreign trade there was to be done by barter, and the country was suffering from a lengthy period of self-imposed economic isolation. The major European nations, Germany, Italy, France, Holland and England responded to Peter's initiatives with financing, training and investment programs as a logical outgrowth of their national mercantile policies, establishing themselves as Russia's trading partners, to the virtual exclusion of everyone else. America was not involved.

Today, President Gorbachev is leading his Soviet citizens, kicking and screaming, into the Western industrialized world. His economy is in shambles, the Russian ruble is almost worthless, compelling foreign trade to be done by barter, and the country is suffering from a period of self-imposed economic isolation that began in 1917. The major Western nations, Germany, Italy, France, England and Japan have responded to President Gorbachev's overtures with financing, training and investment programs as a logical outgrowth of their national mercantile policies. Again America is not involved.

When attempting to trade with the Soviet Union and Eastern Europe, American companies, such as mine, suffer from two major impediments. One is governmental; the other, stock market-imposed. United States trade and credit restrictions and a burdensome export control system, combined with this country's financial community's short-sighted focus on quarterly earnings severely hamper the ability of American companies to deal with the Soviet Union. It is up to American business and the financial community to solve the short-horizon earnings problem, although it may take legislation to get us to focus on the long term. It is up to the Congress to solve the regulatory and legislative impediments problem and I believe that American business is eager to work with Congress find the solution.

Recent OECD trade figures illustrate our uncompetitive position. Out of $21 billion of exports to the Soviet Union by major Western countries in 1987, the American share amounted to only $1.5 billion, two thirds of which were agricultural products. In 1987, the Soviet Union spent almost $6 billion on capital equipment and machinery. The American share was 2.3 percent.

This lack of participation by American companies in trade with the Soviet Union is ironic since the Soviets would prefer to deal with Americans. We, as a nation, are regarded by Soviets as a technological leader, industrious as a people and, perhaps most important, as honest businessmen. Dealing with the United States would signify that the Soviet Union is a real member of the global economy, a member of the world "club" of industrialized nations and an equal participant in modern civilization. This acceptance of the Soviet Union into "our" world is very important politically, economically, and psychologically to the Soviets. Anyone who has dealt with the Soviets for any length of time appreciates this real need of the Soviet people to feel that they are regarded as the equals of the West.

The opportunities for American companies, large and small, are there if we, as a country, act quickly. If we don't, the Europeans will establish their trade monopolies just like they did two hundred fifty years ago. Today we also have the additional factor of the Japanese who are working the Soviet market extremely aggressively.

Modernizing the Soviet economy requires the goods and services, the technical and management skills of American companies of virtually every size. However, to fully exploit this opportunity we cannot simply sit back and wait for a Soviet purchase order to arrive in the mail. We also cannot restrict our thinking to simple exporting. American companies need to go to the Soviet Union for the long term, to essentially build the market. We need to combine in consortia to find ways to solve the inconvertible ruble payment problem and to share the cost of the lengthy process of becoming an important player in that marketplace. America must become innovative in its approach to the Soviet Union to differentiate our commercial offerings from those of our major trading partners. Most importantly, we need the support of the U.S. government if we are to compete effectively with those major trading partners.

The departure of the Eastern European states as economic dependents of the Soviet Union means that the natural resources formerly devoted to keeping Eastern Europe afloat can now be re-directed to providing badly needed consumer products to the Soviet people. The Soviets are looking for partners to help them develop these re-directed resources and to find and develop new resources. Even if the ethnic and political instability on the periphery of the Soviet Union eventually led to separation of the Baltic States and of the Muslim republics, it is important to note that most of the natural resources necessary to modernize the Soviet economy are located within the boundaries of the Russian Republic, which would continue in existence.

American companies are invited to participate in the Soviet economy, as partners with Soviet enterprises, at virtually every level of the economy. The recently signed Tobolsk Joint Venture Project, which my company is leading, is an excellent example of such partnership. A consortium of Western companies and a Soviet enterprise are building and operating a new petrochemical plant in the heart of Western Siberia specifically dedicated to converting natural gas into intermediate plastic products which will eventually be made into shoes, containers and other consumer products. Multi-billion dollar projects like this offer ample opportunities for American firms of every size to participate; however, they take years to develop, require innovative marketing and negotiating strategy, and entail complicated financing schemes. American small businesses are not likely to have the ability to handle such projects alone; but, in partnership with other companies and with the American government, they would have the capabilities necessary to capture that business.

So why isn't America involved and what can we do about it? More specifically, what can Congress do about it?

The root of the problem is that America has no effective mercantile policy. This is in sharp contrast to our major trading partners such as Germany and Japan regardless of what their public pronouncements profess. Business and government co-exist in this country without a common objective and often as adversaries. Business has often been used by government as the instrument of foreign policy, making it difficult for nations such as the Soviet Union to consider us reliable partners and suppliers and costing American businesses billions in lost opportunities. This unreliability issues is an often-expressed worry of the Soviets. The ramifications of the gas pipeline boycott of ten years ago continue to negatively affect American-Soviet trade today. In contrast to their foreign counterparts, American businessmen operate alone, without their government's political and financial backing and often with the threat that an outdated regulatory policy will nullify months and often years of marketing effort.

If we can normalize our trade relations with the Soviet Union, the National Foreign Trade Council estimates that U.S. exports could grow as much as ten times over the next decade. We can only normalize our trade relations with the Soviets if we normalize the trade relations between American business and American government. We need a real, functioning partnership between business and government with a common objective if America is to be involved with the opening of the Soviet Union in more than a token way. We need clarity as to whether the American government wants American business to participate in the restructuring of the Soviet economy and the resultant reform of Soviet society. Why cannot American business count on the American government to be its business partner in the same way as our foreign competitors can count on their governments?

There are several specific government actions that are needed quickly if America is to take a significant role in the opening of the Soviet Union:

First, an effective bilateral trade agreement needs to be established as quickly as possible. As part of that agreement, the granting of Most Favored Nation ("MFN") treatment to the Soviet Union and a three-year waiver of Jackson-Vanik are fundamental to trade normalization. The one-year waiver specified in Jackson-Vanik is too short a period to permit American business to make trade and investment decisions and again raises the specter of relatively quick shifts in American policy causing havoc to existing contracts. The Europeans do not have that detriment. Ultimately, if the Soviet Union continues to make improvements in human rights and immigration policy, repeal of Jackson-Vanik is recommended.

A useful trade agreement will address matters that make it difficult to do business in the Soviet Union such as the inconvertibility of the ruble, and the lack of adequate telecommunications.

American small businesses cannot be expected to have the time, expertise and money to establish elaborate, multiple party credit and currency arrangements to overcome the fundamental "how do I get paid" question. This is a major impediment for large American companies as well. If the trade agreement contained a commitment by the Soviets to dedicate a percentage of the hard currency generated by sales to the United States to the purchase of American-origin goods and services by Soviet enterprises some of the burden of arranging financing could be lifted from American businesses. The Soviets realize that the granting of MFN status initially benefits only Soviet exporters. An allocation as proposed would balance the scales somewhat by creating a hard currency fund supporting opportunities within the Soviet Union for American companies.

Similarly, the Soviets should commit to allocating a portion of their hard currency earned as a result of MFN to American companies who form joint ventures in the Soviet Union to manufacture goods that formerly had to be imported. This credit for "import substitution" should fund, in hard currency, American repatriation of dividends arising from joint venture operations.

Telecommunications are grossly inadequate in the Soviet Union. It is not at all uncommon to place a call to the United States from Moscow and to wait four hours for one of the few international lines to become free. Given the time zone differences, business cannot be conducted with such delays. Outside Moscow, the situation becomes worse. American businessmen in Moscow are effectively isolated from the West, a major impediment to transacting business. Opportunities for American business within the Soviet Union will increase in direct proportion to the availability of telex, telephone and fax communications. This is a problem recognized by the Soviets and an opportunity for our country. If American telecommunications companies could have financial backing, in the form of direct government-to-government credits to the Soviet Union for the installation of modern telecommunications systems, not only would our telecommunications industry obtain a considerable amount of business but the prospects for increased American-Soviet trade would be increased immeasurably.

Second, we need an effective bilateral investment protection agreement. The past several years in the Soviet Union have shown me that a long-term presence in that country is necessary to establish a business's credibility. Simply hoping to export from the United States is unrealistic. Long range transactions do not work. This means significant investment in Soviet-American joint ventures.

At present, Soviet legislation on joint ventures is relatively ambiguous regarding investment protection. While the law guarantees Western investors the return of whatever remains of their investment, how that is calculated, in what currency, and when it is paid out are left to the agreement of the parties. Not even the Soviets know what their own law is supposed to mean in this respect. This has proven to be one of the most difficult areas of joint venture negotiation and has caused many American businesses to decline to make the investment. If the Soviets wish to encourage American investment, they must be willing to reduce both the real and perceived risks of doing so.

An investment protection agreement should guarantee the repatriation of joint venture profits in hard currency. The Soviets should commit to making hard currency available even if the joint venture's profits are only earned in rubles, since the joint venture's operations take the place of imports which would have cost hard currency. They should guarantee freedom from unlawful interference with business operations, specify defined international standards for determination of the liquidation value of joint ventures and a realistic methodology for investor compensation. Given the difficulties inherent in investing in the Soviet Union, sufficient protections must be established to make foreign investors choose the Soviet Union over other countries in which they can invest.

Third, an effective bilateral tax treaty must be established. Currently, the existing tax treaty does not, for example, exempt American investors from the 20% dividend withholding tax imposed by the Soviet Union. Other countries have been able to have that tax waived in their tax treaties. In the case of the Tobolsk project to which I referred earlier, investment was made by means of an Austrian company established to take advantage of the Austrian-Soviet tax treaty. American business needs that advantage just to operate on the same footing as its major trading partners.

Similarly, the U.S. tax code needs to be updated to cover definitively matters such as the value of ruble profits and the availability of foreign tax credits for taxes paid in the Soviet Union. Lack of predictability both in the Soviet tax code and in our own and the fear of double taxation blocks the way for significant American investment.

Last, and in my experience most important, America must substantially revise its export financing and export licensing structure. American businesses simply are not able to compete with German, Italian, French, British and Japanese companies that have the financial backing of their governments. More than two-thirds of officially supported exports to the Soviet Union, or almost $11 billion, come from Japan, Germany, France and Italy. Of nearly $16 billion in export credits and financing made available to companies dealing with the Soviet Union, the American share was three-tenths of one percent (.3%) The U.S. government is the only major Western government that does not provide financing for its exports into the Soviet Union and that is crippling the ability of American business, large and small, to compete.

Private bank financing from the United States is essentially unavailable to American business. Without an Eximbank guarantee, American banks are unwilling to support trade with the Soviets. The Soviets simply do not have the hard currency required to fund the major projects necessary to put the Soviet economy on a sound foundation. Consequently, the trend in Soviet purchasing is to require the Western supplier to provide the financing, something beyond the capability of most small businesses. From personal experience, having been turned down by American banks, I can testify to the willingness of European and Japanese banks to finance Soviet projects. My company has been forced to go to such banks to structure the financing of our major Soviet projects.

The principle impediment to the necessary Eximbank support is Jackson-Vanik. While that legislation was enacted for legitimate purposes, the Soviet Union today is a far different place and American businesses are now the ones hurt by its existence.

Similarly, the $300 million aggregate limit to Eximbank support for transactions with the Soviet Union severely negatively affects the ability of American companies to compete for that market with our major trading partners. Raising the ceiling is only an interim step. What is required is no ceiling, treating the Soviet Union no differently than any other nation with whom the United States has normalized trade relations. Similar legislation imposing limits for certain types of projects and requiring Presidential approval for loans in excess of $50 million are also barriers to trade that unnecessarily hurt American business.

Unless Eximbank is sufficiently and consistently funded, American business has no effective financial backing similar to what our foreign competitors have from their governments. In my experience, observing and trying to meet our foreign competition, this financial partnership between business and government is the very heart of a country's mercantile policy. It exists in all of our major trading partners. It does not exist here. If the business of America is to be exports, the government must establish this reliable financial base to support its industry.

The Export Administration Act ("EAA") should be substantially revised prior to its expiration in September, 1990. A one-year extension would perpetuate the perception of American unreliability and a system which has done more to hurt American businesses than to hurt the Soviets. I personally have had high-level Soviets tell me that they would prefer to deal with my company, but they doubted that we could successfully get through the export licensing process, here and at COCOM, in any practical time, if at all.

If America's priorities are exports and competitiveness, which I believe they should be, the EAA should be revised to give American business an equal chance to compete with our major trading partners. Foreign availability should be realistically considered in our export policy. Time after time, American business has had to watch helplessly while our government struck a policy pose that restricted exports and our trading partners happily filled the void created by the American retreat. Congress has the power to stop this by enacting export controls that reflect the current realities of both the Soviet threat to our defense and of the ability of the Soviets to get what they want from foreign competitors.

Our Export Administration Act must be revised along with substantial revision to COCOM regulations, some of which have not been reviewed since the early 1970's. A realistic appraisal of the necessity of export controls will undoubtedly demonstrate that some are required; however, to continue to restrict exports of American products that are readily available overseas only hurts American business, especially those small businesses which have neither the expertise nor the time and money to fight their way through the bureaucratic process of getting an export license.

In summary, I believe that the opening of the Soviet economy to Western suppliers and investors represents nothing short of another Russian revolution. Great opportunities for American business are already there and more can be created if this country's business and government act together expeditiously. This means a realistic combination of bilateral agreements and export-encouraging direction, financial and foreign policy support. Unless we act properly and quickly, the Soviet market will be monopolized by our European and Japanese competitors who are working as partners with their governments. During the last Russian revolution, America responded by landing armed troops in Russia. American business hopes that our response to this Russian revolution will be to land Americans armed with national purpose and with national financing to meet the competition.

Senator **Lieberman**. Thank you for your very valuable and very important statement.

You know it strikes me, just for the record, both of you have stressed the importance of credit here. Why do you not just describe for the record and for those in the room how Ex-Im Bank works, what does it mean to finance an American business/Eastern European transaction?

Mr. **Madara**. If, in fact you are trying to find financing for a project, the hard currency financing for a project in the Soviet Union or Eastern Europe——

Senator **Lieberman**. You are trying to sell something to somebody in the Soviet Union?

Mr. **Madara**. I have a product to sell. Go to an Eastern European customer and say, this is the price and he says, fine, I have an inconvertible currency. Do you want barter? I will give you paper, I will give you oil, I will give you pulp, I will give you minerals, natural resources.

Fine, but that complicates it. And the average small businessman does not have the expertise nor the time, nor, more importantly, the money, to go find somebody to take that stuff that he gets.

So how do I do it? Well, I could arrange a loan. If I go to a private bank in the United States, they will not negotiate any loans with the East Bloc and the Soviet Union because of the credit risk without a U.S. Government guarantee. That is Ex-Im's role.

Senator **Lieberman**. And the loan is to your purchaser over there? To help the purchaser pay you?

Mr. **Madara**. Exactly, sir. You do not do transactions in those countries unless you first say how do I get paid. And as soon as they say I do not have any hard currency, then the burden is on you. And the small company in Connecticut or Michigan or wherever, cannot go into all of that. We need Government support to put those programs into place.

Senator **Lieberman**. And again, the Western European Government and the Japanese Government are extending that kind of credit to Eastern European purchasers of their goods?

Mr. **Madara**. Absolutely. I have been in some negotiating sessions in which our European competitors are sitting in the next room, and basically, the purchaser is holding an auction, and in that next room is the Ambassador, is someone from the central bank of one of those countries, or ECGD or COFAS, that sort of thing. I turn around, I have got nobody. The American businessman is alone.

Senator **Lieberman**. That is something we cannot allow to happen. That was a great telling of a story in very understandable terms.

I am inclined to go next to Peter, is that right? Peter von Braun not only is from Connecticut, he was my college classmate. Next, there will probably be a member of my family on this panel. [Laughter.]

Would you testify, Joseph Bell, that you and I are not related in any way?

Mr. **Bell**. We are not related, and I am not from Connecticut.

Senator **Lieberman**. OK. It happens that these are all outstanding witnesses, as you can tell. They are not chosen just because they happen to be from Connecticut. But Peter is the head of a small business there that has done something very big in the Soviet Union, and we would now like to hear about it. Thank you for being here.

STATEMENT OF DR. PETER C.M.S. VON BRAUN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF AMERICAN MICROTRACE CORP., AND PRESIDENT OF RUSPETROL, LTD.

Dr. **von Braun**. Thank you, Senator. The theme of my discussion is very much to do with the small business development in Eastern Europe which is the hope of that region in the world. I think that the United States can play a crucial and a very constructive role in providing economic, environmental, and intellectual leadership to the restructuring of those economies.

Senator **Lieberman**. Just take a minute, maybe you are going to do it anyway, and just explain what your involvement has been in Eastern Europe.

Dr. **von Braun**. One of the things we did last year was negotiate a joint venture agreement with the Soviet State Committee for Public Education, which was announced by the Soviets in New York in September. They are sourcing personal computers through this joint venture. The Soviets announced that they expected to purchase or procure six million PCs with a market value of somewhere between $6 billion and $9 billion, which makes it a reasonably large U.S. export order.

Senator **Lieberman**. Yours is really a small company, though?

Dr. **von Braun**. Yes. What we learned very clearly as a result of our experience is that the Russians will buy anything you can pay for. The other witnesses have talked about the need to create financing. And what we are involved in now is the development of increased oil recovery in the Soviet Union through a microbially enhanced oil recovery process, owned by a small business in Texas, to generate the incremental oil which can be traded on oil markets to finance the imports.

I agree with the other witnesses that it is terribly important to increase U.S. credit but, on the other hand, it is as important and perhaps more so, for American businesses to be creative and inventive in terms of inventing new ways of getting paid. I think the burden is on us as well as on Government.

The other witnesses have talked about going into negotiating sessions with rivals in another room fully supported by their diplomatic corps and by representatives of their Government, their banks, and everything else. Absolutely true. The U.S. Department of Commerce provides people in the various embassies, and they are very nice and they are very helpful but they do not have the muscle or the clout that their German, or British or Japanese counterparts have.

And when a British trade mission comes into a country in Eastern Europe, they turn out at the airport with Rolls Royces and bring them in. They treat businessmen as important. Frankly, symbols are terribly important in Eastern Europe and if you are not treated by your own country as being important, why should foreigners think you are? They honor business.

And that is getting me a little bit off the track and that is in response to your question, Senator, but since my testimony is written for the record, the fact that I depart from it is not going to hurt.

Senator **Lieberman**. Not at all, and I thank you for doing that.

Dr. **von Braun**. I would very much like to congratulate you on the legislation that you introduced. I would like, for the record, say that I did not copy it. The fact that your legislation is very similar to my testimony is coincidental.

Senator **Lieberman**. It is attributable to the education that we received together.

Dr. **von Braun**. Absolutely. Thirty years ago at Yale they knew what we would be doing today.

I would like to argue that U.S. policy with respect to small business must be proactive. Small business is really the hope for Eastern Europe for a couple of reasons. As these countries move from central planning to a free market economy, an enormous amount of structural unemployment is going to occur. My best guess is that approximately—it will vary country by country—but somewhere between 25 percent and 50 percent of the workforce is going to require new jobs, real jobs, productive jobs in a real economy.

This structural disemployment will create an enormous cataclysm if it is not dealt with. This massive job formation process can only be driven by small business. Our policy should be quite proactive and, I think, quite disciplined with respect to our aid program to Eastern Europe.

I believe we need to focus on four things. First, we have to be advocates for small business. This is a role that we can uniquely play because we are the world leaders in small business.

Western Europe has not been successful in creating jobs over the last 20 years. We have. We have done it in the small business sector. And some of these companies have grown from small businesses to multibillion dollar companies. For example, in electronics—Compaq and Apple did not exist or were tiny 10 years ago. Today they are multibillion dollar companies. This is the path of U.S. growth. More important for today's discussion, it is the path that Eastern Europeans need to grow along.

Second, we need to help Eastern Europe with regulation. We have an enormous amount of know-how in creating a positive, regulatory environment within which small business can flourish. We need to work with the Eastern European Governments, including Russia, to remove the barriers that prevent the growth of small business.

In certain countries, the kinds of routine economic activities that underlie small business operations are punishable by very severely, including by death, which will ruin your day. [Laughter.]

Senator **Lieberman**. Not to mention your business.

Dr. **von Braun**. Yes. Third, we need to create the information exchanges in a far more disciplined way than we have now. Fourth, we need to set up among several institutions including a Small Business Development Bank that would provide hard currency, long-term loans. These would create the equity for local currency lending activities to small business. This bank ought to have three windows: A general business window, an agribusiness window to finance the enormous number of small businesses that are necessary to make the food production chain work in those countries, and an environmental business window that finances the kinds of businesses that are needed to clean up the Eastern European environment.

To the last point, in Poland, for example, 50 percent of the farmland has been contaminated by heavy metals because the Poles do not have the simple technology that we do—I am being a little self-serving, my company developed it—that they can use to treat the metal waste that they are spreading on the fields. This technology removes the lead and cadmium contents and create an environmentally sound product that can be used for plant and animal nutrition.

Those are small business technologies which are, using your phrase Senator, genius-intensive and not capital-intensive. These are the solutions that only can be stimulated at the small business level.

We have got a range of things which the United States can do but I would argue, Senator, that we must emphasize the role of small business in creating social, political, and economic stability in Eastern Europe, without which any infrastructure development really does not make any sense. We have to give these countries stability and jobs are how to do it.

Senator LIEBERMAN. And you are stressing that we should be doing that—you are talking really about Eastern European small businesses? In other words, creating——

Dr. VON BRAUN. U.S. small businesses can play a major role in that. But we must create the conditions for small business growth in those countries if there is going to be a market for anybody to sell anything to—except ourselves. I mean, the U.S. can lend money to the Russians to buy mammoth projects which they will build and ruin, but there will be no self-sustaining growth without a small business engine underlying that whole process.

Senator LIEBERMAN. Thank you.

[The prepared statement of Dr. von Braun follows:]

SMALL BUSINESS DEVELOPMENT - THE HOPE OF EASTERN EUROPE

TESTIMONY OF DR. PETER C.M.S. VON BRAUN
BEFORE THE
COMMITTEE ON SMALL BUSINESS
OF THE UNITED STATES SENATE

MARCH 23, 1990

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MARCH 23, 1990

INTRODUCTION

The United States can play a crucial and constructive role by providing economic, environmental and intellectual leadership for the effort to restructure the economies of Eastern Europe, including the Soviet Union*. These countries are going through a period of intense turmoil and require, above all, a period of stability to work out their own social, political and economic arrangements.

The central theme to my testimony is the proposition that achieving stability in Eastern Europe will require job creation on an enormous scale. The shift from centrally planned to market economies will cause a massive job dislocation, making the creation of new jobs the number one priority for achieving stability in Eastern Europe. The United States, alone of the major economic powers, has a unique contribution to make in solving this huge unemployment problem* through the support and development of small businesses throughout Eastern Europe. And, the problems of the Soviet Union must also be dealt with because, as President Havel of Czechoslovakia said during his visit to Washington recently, Soviet problems have a powerful affect on the stability of its neighbors.

The United States has an unique opportunity to stimulate the process of job creation in Eastern Europe. The approach I am suggesting is quite different from the calls to revive the Marshall Plan and pump very large amounts of funding into Eastern Europe at great cost to the American taxpayer. The proposed approach has the happy coincidence of being both correct for the situation and economical. However, it may not be glamorous enough to generate broad support. It involves a lot of hard work. But remember, it took the Communists and the Central Planners 45 to 70 years to create the mess that needs to be cleaned up. It will take at least 5 to 10 years to deal with many of the problems created by Communism.

* Note: For purposes of simplicity, the term "Eastern Europe" includes all of the former Soviet Satellites and the Soviet Union.

** Note: More accurately, the problem is under-employment as large numbers of people now hold titular jobs.

Lest my testimony be cast in a "jobs at any cost" light, let me emphasize the urgent need for action on the environmental front in Eastern Europe. Indeed the two problems must be approached simultaneously, as many parts of Eastern Europe and the Soviet Union have become so environmentally contaminated that human life as well as economic development is threatened. Moreover, the environmental problems affect areas well outside the region. Small business has a significant role to play in assisting Eastern Europe deal with their environmental problems as well because many of the most promising environmental technologies have been developed by small business in the United States. It is not an exaggeration to say that the environmental rehabilitation of Eastern Europe probably can not be achieved without the active involvement of small business in the United States.

I. SMALL BUSINESS DEVELOPMENT - THE BEST CONTRIBUTION THE U.S. CAN MAKE

Small business can make an enormous contribution to solving the employment problem in Eastern Europe and this area should be the focus of U.S. Government policy and programs. Five simple facts underlie my recommendations for small business development:

1. Job creation will be the greatest contributor to achieving stability in Eastern Europe and, most particularly, the Soviet Union.
2. Small business is the best job creation mechanism for Eastern Europe.
3. U.S. small business controls vital environmental technologies which need to be employed in Eastern Europe and the Soviet Union.
4. Barriers preventing small business development in Eastern Europe must be removed.
5. Developing an effective small business infrastructure in Eastern Europe is a unique capability of the United States.

REAL JOBS ARE NEEDED TO SUPPORT REGIONAL STABILITY

Centrally planned economies are inefficient in practice, both in the allocation of resources and in the creation of goods and most particularly, services. The Eastern Europeans themselves have recognized the need to make their economies more efficient through shifting toward more market-oriented economic systems. These countries hope to be able to lift their standards of living through higher productivity. However, the United States must recognize that any attempt to make the economies of Eastern Europe more efficient is bound to create large-scale unemployment in the short term. The following are but two illustrations of why job dislocation will be a major problem:

1. Over Staffing in Industry: Many informed observers argue that heavy industry in the Soviet Union and Eastern Europe employs 2 to 5 times as many workers as would be needed under reasonable Western standards of productivity.
2. Inefficient Agriculture: Most Eastern European countries employ 20 to 30% of their work force in agriculture, but even so, some can not feed themselves. For example, 30% of Soviet agricultural production takes place on the 2% of the land permitted to be used for private cultivation. The levels of productivity on the land controlled by collective farms are much, much lower. By contrast, only approximately 2% of the U.S. work force is involved in agriculture, yet the U.S. is the world's largest exporter of agricultural products and still consistently produces surpluses.

Let us consider the employment implications of improving productivity in these two sectors of the economies of Eastern Europe. Economists can, and will wrangle for decades about current Eastern European employment levels in various economic sectors. One source argues that between 40% and 60% of Eastern European workers are employed in industry. Let us assume that 40% are employed in industry and 20% in agriculture. Let us also assume that these economies only achieve half the productivity levels of the United States or Northern Europe. The job dislocation effect of these changes would be staggering:

Any significant move towards enabling greater levels of private farm management will dramatically increase productivity. The great benefit of this is that Eastern Europe will soon be able to feed itself. At the same time, increased productivity will dramatically lower agricultural employment. For example, if agricultural productivity in Eastern Europe reached only half of the level achieved in the United States, where only about 2% of the work force is employed in agriculture, Eastern European agricultural employment would drop to about 4% of the work force. The effect of this would be dramatic. For example, in the Soviet Union, it would eliminate the equivalent of 24 million jobs in agriculture alone out of that country's total employment of 150 million. Similarly, such a move would eliminate about 5 million out of the total of 19 million jobs in Poland and about 750,000 jobs out of a total of 5 million in Hungary. Dislocations of this magnitude would deal a devastating shock to these countries' social and political structures.

The situation in heavy industry is similarly severe. Placing these industries on at least a break-even basis would have devastating effects on employment. Many estimates are that employment would be reduced to one half, or even a quarter of current levels, even if production was increased.

The most significant effect of subjecting the economies of Eastern Europe to rational market forces will be the need to create new jobs for anywhere between 25% and 50% of the current work forces of these countries. This is an enormous price to pay for economic rationality. On the other hand, it is impossible to sustain the current Eastern European economic structures, which are crumbling as we speak. Therefore, priority must be given to dealing with the consequences of these economic changes, which have been initiated by the Eastern Europeans themselves.

Failure to deal with this grave problem of structural unemployment will result in social and political chaos. The consequences of this chaos would inevitably be negative, both for these countries and for the United States.

SMALL BUSINESS CREATES JOBS AND STABILITY

The two areas of the world which have been most successful in creating new jobs are the United States and the 4 Tigers of Asia - Taiwan, Hong Kong, Singapore and Korea. Each in its own way has relied on small business to create jobs. The U.S. experience is most relevant to Eastern Europe because it involves economic restructuring, not just economic growth from a small base.

The United States has created approximately 20 million net new jobs since 1980. This is the result of creating a total of some 27 million jobs, almost exclusively in small and medium-sized business, which offset the loss of some 7 million jobs in large business. In the U.S., small business job creation is a process of market-driven renewal through innovation to offset stagnation amongst the largest employers, many of which have been downsizing rapidly.

U.S. Census data supports the importance of small business in the job creation process. For example, Census data suggests that 50% of all jobs are created by companies with no more than 10 employees and 80% of all jobs by companies with no more than 25 employees. Small Business Administration analysis indicates essentially the same relative importance of small business in the job creation process.

By contrast, Western Europe has not been effective in creating new jobs since the 1970's, when the economic surge created after the end of World War II began to slow. Much of Northern Europe's economic resources has been focused on trying to prop up traditional industrial sectors, such as coal, steel, etc., often at the cost of small business. Small business in Western Europe often has been shackled by a mind numbing, bureaucratic regulatory structure. Furthermore, the financial and service infrastructure for small business has been neglected. The competitive structure of these markets has also made it difficult for small businesses to grow. The net result - inadequate job creation.

Where, then, will the jobs come from? This is a fair question and deserves a studied answer: new jobs in Eastern Europe will primarily come from supplying goods and services which are not now being provided. I gave two examples of sectors where traditional forms of employment will decrease sharply. The corollary is that solving major problems in these sectors will increase employment in other areas, probably by as much or more. The answer to the disemployment problem is to free up small business to meet the new demands for goods and services.

For example, in agriculture: one of the major reasons why there are food shortages in a country such as the Soviet Union, is that the food storage, transportation, processing, distribution and retailing industries are largely nonexistent or appallingly inefficient. An illustration: A significant portion of the potato harvest in the U.S.S.R. rots before getting to market because none of the distribution support services function well.

If the Soviet Union encouraged the formation of the hundreds of thousands of small businesses which participate in the food distribution chain in a market economy, not only would there be an increase in the availability and variety of foodstuffs, but millions of jobs would be created as well. In short, intelligent agricultural development policies can create the millions of jobs in small business needed to offset the massive loss of jobs on the farms themselves.

Likewise in industry, freeing up small business would create millions of new jobs in supplying consumer goods and services, now in extremely short supply. Not long ago, I spoke with a young Soviet-American entrepreneur, who had developed an extremely profitable business importing used clothing into the Soviet Union from the United States. He reckoned that he achieved the equivalent of a 80 to 1 exchange rate from the ruble to the dollar. In short, for every dollar he invested in supplying used clothing from the U.S., he earned 80 rubles in the Soviet Union. No high technology, no mystery, but most importantly, no reason why clothing could not be produced by small companies in Eastern Europe, in the same way that as clothing is produced all over the world.

A massive increase in the number of real jobs is the most urgent economic requirement for the revitalization of Eastern Europe. The support and development of small business is the most effective way of coping with the impending employment disaster threatening each of these countries. In aggregate, small business creates jobs on a far more massive scale than any massive industrialization program can possibly do.

Another, and perhaps major, advantage of permitting the development of small business is that it absorbs an enormous amount of social energy. If Eastern Europe, and most particularly the Soviet Union, continues to emphasize political freedom at the expense of economic freedom, most of the energy of the population will be directed towards trying to find ideological solutions to problems which are essentially economic in their nature. When most of the populations' energy is directed towards politics during a trying period of reform, tempers may begin to run very short, governments may become unstable, and society moves at least one step closer to chaos. Channeling this energy towards creating a vital and dynamic small business sector will help to stabilize the political structures of Eastern Europe.

In addition to the ability to create jobs on a massive scale, and create a greater degree of political stability, small business also creates a far more stable social structure than dependence on heavy industry or giant employers alone. Small business people create an independent economic base for a wide variety of social activities. Eastern Europe desperately requires a vital small business sector if it is to prosper economically, socially and politically in the future.

However, there also must be a land in which people can live for a society to prosper. Therefore, environmental action is a critical need to creating sound new jobs in Eastern Europe and the Soviet Union. The next section of my testimony deals with this issue.

SMALL BUSINESS IS VITAL FOR SOLVING ENVIRONMENTAL PROBLEMS

Eastern Europe's environmental problems are a nightmare. Unless they are addressed rapidly, economic recovery on any meaningful and long-term basis may not be possible. Let me cite just a few examples from the environmental catalog of horrors and some discussion of the impact of these environmental problems and how U.S. small business can work to solve them.

An important theme running through these three examples is that small business normally seeks solutions to problems which are genius intensive, not capital intensive. This is because small business normally is capital constrained and can not afford gold plated or capital intensive solutions. However, these are exactly the kinds of solutions which Eastern Europe needs to deal with its own environmental problems.

> Case #1 Municipal Waste Treatment: Municipal waste facilities in Eastern Europe and the Soviet Union do not have the capacity to treat the levels of waste created by their populations. As a result of overburdened facilities, and lacking the money to build additional capacity, untreated or inadequately treated waste is dumped on the land or in the rivers, lakes and seas surrounding these countries creating enormous pollution problems.
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> U.S. small business has developed and commercially proven technologies which can use biological techniques and processes to increase the productivity of existing municipal waste treatment facilities by over 50%, improve the treatment of the wastes, and reduce the mass required for disposal by approximately 50%. These products and the techniques for using them do not require any significant capital improvements to the existing plants and can be implemented within weeks.
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> Case #2 Contaminated Farm Land: Approximately half of Poland's farm land has been contaminated by heavy metals to the point that plant uptake of these toxins makes eating the crops hazardous. Testing of livestock is just beginning to determine the levels of lead and cadmium poisoning. Since the Polish economy must develop markets for its agricultural produce in Western Europe, it may find itself cut off from a natural path of economic development. This problem is not confined to Poland, but is common throughout the area. In fact, it is not unknown in the U.S.
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> Much of this problem comes from the practice of using raw or semi-treated industrial waste to replace mineral micronutrients lost in the soil or to provide mineral supplements in animal feed. A first step in solving the problem is to stop increasing the levels of heavy metals in the soil and animal feed.
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> U.S. small business has developed and commercially uses an economically and environmentally sound technology to solve this problem. The solution involves chemically treating mineral wastes from steel, brass and other metal processing industries (the most common source of mineral micronutrients), removing or reducing the heavy metal content to environmentally safe levels, producing mineral micronutrient products for animal and plant nutrition, and recycling the heavy metal residues through smelters to reclaim the lead and cadmium content.

A plant employing this technology and capable of producing enough primary mineral micronutrient products to meet Poland's annual requirements would cost between $10 and $20 million and would create a viable business as well as solving a vital environmental problem.

Case #3 Chemical Waste Pit Treatment: There are literally thousands of toxic chemical waste pits scattered around Eastern Europe and the Soviet Union. These toxins invade and contaminate water tables and aquifers, spreading pollution of wide areas.

U.S. small business has developed and commercially uses an economically and environmentally sound technology to solve this problem. Microbial technology permits the in situ treatment of chemical waste pits to neutralize toxic materials. In addition, benign, naturally occurring microbial remediation material can be injected in aquifers to treat the contamination there as well.

These are just three examples of the capabilities of U.S. small business to make a major contribution to solving the environmental problems in Eastern Europe. In fact, there are literally hundreds of other examples which could be cited.

BARRIERS TO SMALL BUSINESS FORMATION MUST BE REMOVED

Small business suffers from a variety of handicaps throughout Eastern Europe, ranging from legal prohibitions to ignorance about how to form and run a small business. These handicaps fall into four groups:

1. Legal restrictions: these include from it being illegal to carry out routine business activities such as sourcing raw materials and supplies, renting premises, employing workers or holding inventory for sale. In many cases these practices are still considered "economic crimes", for which there are severe penalties, including death. The most flagrant of these barriers tend to be breaking down, but not quickly enough and without the prompt implementation of the regulatory revisions that make the new legislation operative.

2. Administrative and bureaucratic obstructionism: even when small business is legal, the old guard administrators still have many weapons left to prevent business from flourishing. For example, it has been reported that in the Soviet Territory of Krasnodar, bureaucrats killed over 1,000 small businesses in 1989 alone. Extend that statistic throughout Eastern Europe and one begins to understand the magnitude of the problem. The weapons still in the hand of Party functionaries include such things as confiscatory taxes, stifling limits on access to raw materials, price controls on private business in the face of enormous subsidies of state enterprises, harassment of workers, denial or revocation of permits, etc.

3. Ideological Barriers: No one can or should force people to change their opinions. However, as a corollary, the power of the state and a state-influenced press should not be used to destroy or damage the very sector of the economies of Eastern Europe holding the greatest promise for the future.

   Entrepreneurs are now being castigated as exploiters and robbers and no attention is being paid to the vital role they play in the development of an economy and a society. Some sort of "equal protection" and advocacy concept needs to be developed and implemented.

4. Absence of a small business infrastructure: This infrastructure is largely lacking in most of its most important elements. The legacy of how to run a small business is weak to nonexistent in most of Eastern Europe. Education is a vital part of the infrastructure which needs to be created. Financial institutions, distribution systems, trade associations, and professional services are but a few of the infrastructure elements which are required. However, each of these needs is also an opportunity for job creation on a rapid and massive scale.

The foregoing comments are only a brief summary to the obstacles to the development of a healthy small business sector in Eastern Europe.

SMALL BUSINESS DEVELOPMENT IS A STRONG SUIT FOR THE U.S.

The United States is uniquely positioned to provide the leadership for the support and development of small business in Eastern Europe. We are the world leaders in small business. In addition, the U.S. has a phenomenal resource in the number of first and second generation Americans of Eastern European descent who have significant skills in small business - largely because many of them are small business people themselves.

We also have the most effective infrastructure in the world for supporting and developing small business, ranging from government programs and personnel, to widespread educational programs and financial institutions working with small business. In short, we are the world's masters in the "technology" of small business. This is a forgotten technology in many parts of Eastern Europe. In some parts, it virtually has never existed or has been liquidated. It will need a great deal of help to rejuvenate.

Most importantly, we care about small business and recognize its importance. Why else would there be two Committees on Small Business in the Congress, each with such a distinguished and active membership? And, because we care about small business, we are much more likely than any other country to do a superb job of not only advocating those steps vital to the development of a creative, strong and growing small business sector in the economies of the Eastern European countries.

II. RECOMMENDATIONS FOR U.S. POLICY

There are five major building blocks upon which a program of Government action should be built, specifically:

1. Advocacy
2. Regulatory Assistance;
3. Education;
4. Information; and
5. Infrastructure Development Assistance.

Each country will have certain specific requirements and characteristics which must be considered, Also, I am not proposing a specific administrative structure, rather I want to emphasize the functions and missions which need to be carried out. There are many mechanisms through which these could be implemented. For example, the 1989 Trade Bill could be amended to include a significant role for small business, the Small Business Administration could be assigned appropriate duties, the Department of Commerce could increase its trade and development capabilities, or the Polish and Hungarian Funds could be asked to develop Small Business Support Programs. However implemented, I would like to make the following substantive recommendations:

1. ADVOCACY

We must dramatize the need for small business development to Eastern European Governments - not as an afterthought, but as a fundamental element of U.S. policy. If we don't act as if small business development is important, why should the leaders of Eastern Europe place any value on small business? Simply because Americans accept the importance of small business, it does not mean that governments and societies with little or no experience with it will automatically develop an accurate appreciation of what small business can do for their countries and their people.

2. REGULATORY ASSISTANCE

We must help Eastern Europe understand how to deregulate their economies. If these countries fall into the hands of the "regulomaniacs" of the EEC, small business will never have a chance to flourish. The United States can provide an enormous amount of experience and guidance to Eastern European on how to create a healthy regulatory environment within which small business can flourish. We have centuries of experience in the legal, tax, and regulatory needs of a sound small business sector. This experience is an important element of the "know how" of small business development.

In addition to government legislation and regulation, significant assistance needs to be provided to Eastern Europe in establishing accounting standards and harmonizing these with the development of small business tax law.

3. EDUCATION

We must institute a systematic program of education for small business people in Eastern Europe, starting with the most basic skills which may have been forgotten, or never learned in a centrally planned economy. A number of institutions, including the United States Information Agency, could play an important role in organizing the educational assistance process. There are a variety of steps we can take. For example:

A. Provide materials: We can distribute English and local language versions of the incredible range of "How To" books developed in the U.S., either in their present form, or adapted to local conditions. Video materials translated into local languages can help broadcast the message and, incidentally, fill a television programming gap and create a stronger degree of acceptance of the role of small business in Eastern European countries.

B. Sponsor educational exchanges: There are already a growing number of educational exchanges focusing on the business sector. However, these tend overwhelmingly to be focused on MBA types of programs. While MBA programs are valuable, what Eastern Europe really needs are programs designed to train small business people, not the next president of General Motors. The United States has a phenomenal base of skilled educators who understand, like and advocate small business. Let us sponsor educational exchanges leading to the development of widespread high school, university and adult educational programs in small business skills throughout Eastern Europe.

C. Involve Business Organizations: The United States has a range of organizations which play vital roles in our small business development process. At the risk of singling any of these out, Junior Achievement could make a major contribution in the Eastern European schools by organizing its programs there so that young people could get a taste of what small business really is and can do. This is only one example of what could be done. The International Service Corps of Retired Executives is an example of another organization which could make a major contribution to the development of small business in Eastern Europe, were it to work with government, financial institutions and small business advisory groups.

4. INFORMATION

We must develop a network of information which can serve the needs of small business people in the U.S. and make it easier for them to get involved in the economic development of Eastern Europe. Small businesses and individuals wishing to do business in Eastern Europe need to be able to tap into sources of information and expertise about how to do business there. Part of this task is to pull together data on all of the assistance programs currently and prospectively available, as well as on what types of business partners are sought by various Eastern European countries. Another level of assistance is to strengthen the staffing dedicated to business development in U.S. embassies and consulates and increase the number of trade missions. Additionally, information on what type of expenses incurred in investigating and developing potential business opportunities are allowable deductions for U.S. federal tax purposes would be a significant stimulus to encouraging small businessmen to become active in Eastern Europe.

5. INFRASTRUCTURE DEVELOPMENT

We must assist in the development of the economic infrastructure necessary to support small business in Eastern Europe. However, it is important to point out that under this concept, the host country would have to put up significant resources in cash or in kind. The "sweat equity" principle would be a key element underlying each of the proposed institutions. Ignoring the sweat equity concept would make the program too much of a "free lunch" and reduce the cost/effectiveness of the program, and hence the return to U.S. taxpayers.

This aid should have strings attached to it. Unless the host country takes active steps to encourage small business, the types of aid described below should not be provided on any large scale. The United States needs to project a point of view about how to build a modern, market oriented economy. Money which will be used for purposes which run counter to the type of restructuring so desperately needed in Eastern Europe will be wasted and should be returned to the American taxpayers. The types of infrastructure development activities I am recommending are summarized below:

A. Eastern European Small Business Development Foundation: This organization should initiate, syndicate and supervise public and private grants in support of the development of small businesses, education, and infrastructure in Eastern Europe. It would serve as the "soft window" in the overall financing small business support infrastructure. About 50% of its funding should be allocated to investments with a prospect of recovery of capital and a reasonable interest rate, or profit participation, and the other half could be provided on a matching grant basis - that is that the host country would put up funds or services equivalent or greater in value than the U.S. funds provided. The Foundation would have the ability to enter into cooperative arrangements and joint ventures with other institutions to leverage its resources in support of its mission. However, the Foundation would not make grants or loans for major physical infrastructure projects, such as roads, power systems, telecommunications networks, etc.

B. Eastern European Small Business Development Bank: The Small Business Development Bank would function as a "partner" of the Development Foundation to stimulate U.S. and host country investment and lending to small businesses in Eastern Europe. This institution would differ sharply from the proposed Eastern European Bank for Reconstruction and Development, in that it would have a specific focus on small business and not on giant projects. The Small Business Bank would provide longer-term "capital account" loans to support lending programs sponsored by indigenous or joint venture institutions with American or other financial partners. It would help to create structures similar in concept to SBICs, except that the modest hard currency subordinated loan from the Small Business Bank would serve as the "capital" supporting local currency borrowing and lending. The bank also would work in cooperation with existing U.S. foreign trade financing programs, such as the Export Import Bank and OPIC.

The Small Business Bank would have three "windows" or types of lending programs:

1. The General Small Business window, to which any soundly conceived

2. The Agro-Business window, whose programs would be designed to stimulate agricultural production through land lease and purchase financing, , equipment lease and acquisitions, and productions input financing, such as seed and fertilizer. In addition, this window would deal with the improvement of agricultural product storage, transportation, processing, distribution, and retailing.

3. The Environmental Business window would develop financing programs to stimulate small businesses specifically working in the environmental area.

C. Eastern European Technology Exchange: This capability could function as an adjunct to the Development Foundation and would work in cooperation with the trade development personnel attached to U.S. embassies and consulates, and the U.S. Department of Commerce. There are a wide range of basic technologies which could and should be provided to Eastern Europe. For example, it would be extremely valuable for U.S. business and for the development of the Eastern European economies to maintain a register of all of the non-restricted technologies to which Eastern Europe would like to gain access, as well as the technologies or know how possessed by the Eastern Europeans for which they thought there might be a potential market in the West.

Beyond its general responsibilities, the Technology Exchange would be specifically responsible for identifying Eastern European needs in the environmental and agricultural sectors and determining opportunities for small business development to meet these needs. The role of this institution would be essentially that of an information source and facilitation agent.

D. Eastern European Business Skills Corps: While the Peace Corps springs to mind as an analog for skills provision, the level of assistance should be on a more sophisticated basis, and very possibly, on a shorter time frame or even part-time. Also, the Skills Corps concept would be far more active in seeking out and developing opportunities. To the extent that its members spun out to work actively in the development of business opportunities, it would be considered a victory rather than someone deserting the cause.

There are a large number of mid-career, semi-retired, and retired professionals with experience working with small business. Many of these people are first or second generations Americans of Eastern European descent who retain some language capability. Many other Americans would be willing to learn enough of a language to make themselves very useful in Eastern Europe. Support grants should be offered to allow these people to spend time in Eastern European countries working on a direct exchange basis or on projects developed by other U.S./Eastern European institutions.

E. Eastern European Export & Foreign Exchange Commission: Eastern Europe will have a significant problem in establishing its currencies as freely convertible and generating foreign exchange. The purpose of the Export & Foreign Exchange Commission would be to develop mechanisms for small businesses to mobilize existing sources foreign exchange or develop new sources through counter-trade in order to fund the importation vital materials from the United States.

The Export and Foreign Exchange Commission would have a second function: stimulating two-way trade between the United States and Eastern Europe. Initially, bilateral trade would help to overcome the foreign exchange problems of Eastern Europe. Longer term, the Commission's Export/Import function would justify itself through the development of trade between the United States and the Eastern European countries.

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As you can see, the concepts underlying the proposed aid program to Eastern Europe are fundamentally different from that of the Marshall Plan. The Marshall plan was designed to pump money into economies which were free market oriented, which had an experienced, efficient, market-oriented work force, but which needed to rebuild their physical productive capacity. A secondary effect was to reintegrate West Germany into a system of European economic and political institutions.

Creating massive institutions to make huge loans or grants to Eastern Europe would be a great mistake and prolong the period of economic chaos and dislocation. Gigantism has always been a passion of Communist economic theory and practice. Giant projects are thought to be prestigious in Eastern Europe. They have also been giant failures and great wastes of talent and resources. But the habit dies hard. If we make enormous funding available for massive projects, it will be spent and wasted. Most importantly, precious time will have been frittered away along with our money.

The problems faced by the Eastern European economies are much different. They need to restructure their economies in a most fundamental way. This requires developing a new and comprehensive understanding of how business works, and most particularly, the vital role that small business plays in driving the massive job creation process necessary for the development of the economies of all of these countries. Eastern Europe doesn't have to replace bombed out factories, bridges and cities. In most cases there is enough physical infrastructure to support significant economic growth. What they need is a massive number of real jobs. Only small business can create these in any meaningful and democratic way. Once the jobs have been created through the growth of millions of small businesses, the tax base will have been created to furnish the physical infrastructure required for further growth.

Footnote: Nothing in these remarks is meant to denigrate the role which can be played by our large industrial and financial enterprises in the redevelopment of Eastern Europe. Much of the U.S. infrastructure they need is in place and many large U.S. large businesses are very active in Eastern Europe. Big Business can be counted upon to advocate those steps they feel are needed to support their interests without any particular encouragement from the U.S. Government. My intent in this testimony is to describe the unique and distinctive role which United States small business can play in addressing the most important economic needs in Eastern Europe.

BIOGRAPHICAL SKETCH OF PETER VON BRAUN

Peter von Braun has extensive experience in international relations, economic development and business. Born in Greenwich, Connecticut, he attended public and private schools in the area, before entering the U.S. Armed Forces in 1957. Upon completion of active duty in Europe and Asia, he entered Yale in 1961. Braun majored in Eastern European history, and graduated with high honors in 1964. He attended the University of Cologne, Germany as a Fulbright Scholar, receiving his PhD (summa cum laude) in 1966. He has published extensively, including a books on Anglo-Russian conflicts in Central Asia and Ophthalmology.

Braun joined McKinsey & Company, international management consultants in 1966, later becoming a partner in the New York office. In addition to working with a wide range of multi-national clients, he also was extensively involved in economic development programs. These included several years of volunteer work with the Congress of Racial Equality in developing Black-owned small businesses in the New York area, as well as redeveloping the coastal fishing industry in Labrador, Canada. These efforts involved integrating "outsiders" into a market economy.

Upon leaving McKinsey in 1977, Braun worked in Africa and the Middle East on economic and health development projects, including developing and implementing the rural ophthalmic program in the Sultanate of Oman. In 1980 he started Leyton Associates, an international consulting firm responsible for assignments in Europe, Asia and Latin America.

He is Chairman and CEO of American MicroTrace Corporation and is President of RusPetrol Limited, a company involved in enhanced oil recovery and which intends to operate in the Soviet Union and Eastern Europe. Braun also serves as an officer and director of several private corporations. He served as Vice Chairman of the Board, Deputy Chief Executive and a Director of The Phoenix Group International, Inc. during the initial development of its business in the Soviet Union, including personally negotiating the computer joint venture announced by representatives of the Soviet State Committee for Public Education in September 1989 as being the vehicle through which they hoped to source 6 million units by 1995.

Braun served seven years as a member of the Vestry of Trinity Church (Wall Street), a director of the Presiding Bishop's Fund for World Relief of the Episcopal Church, as representative of the Episcopal Church on the Board of Church World Service, and as Chairman of the Battle Harbour Foundation, and the Anglican Service, Training and Relief Organization.

Senator **Lieberman**. Joseph Bell of Hogan & Hartson in Washington.

STATEMENT OF JOSEPH C. BELL, HOGAN & HARTSON, WASHINGTON, DC

Mr. **Bell**. I want to bring a little different perspective to these matters. Beside the business opportunities that are going to be available, much is going to depend in large part on the success of reform in these economies. If their market reforms are not successful and we end up with a group of Argentinians in Central Europe, or if the Soviet Union falls into economic chaos, which is certainly possible, then the real possibilities that do exist in these markets simply will not be realized.

I would like to focus a little bit on some of what I think are very pressing matters that need to be addressed at this stage to really create the possibilities for these markets to go forward.

Senator **Lieberman**. Why do you not just mention for a moment your experience? I gather you have been doing a lot of work with the Polish Government?

Mr. **Bell**. Yes. Most of my work has been either in Poland or in the Ukraine, which gives me an interesting set of contrasting experiences. I have been working with the Polish Ministry of Finance, since the new Government took office, largely on a pro bono basis. And I think, rather than talking about what we are doing, I think what is important is to realize what the Poles have done.

There has been a lot of discussion here about convertibility and about reform. The truth of the matter is that the only country that has yet put together and really started the hard part of economic reform has been Poland. And it is really remarkable what they have done, if you look at what has happened just since the first of January when they initiated their reform program. They have eliminated virtually all price controls. They have abolished the central allocation of import and exports.

We have talked about the problem of currency and convertibility. Well, the Poles have established so-called internal convertibility, and as a matter of principle, at this moment, any Pole who wants to import can obtain the necessary hard currency to make that import from a foreign supplier. So one of the major problems, particularly for smaller suppliers, in dealing with Eastern Europe has been taken care of in Poland.

We have not even begun to approach that elsewhere and certainly not in the Soviet Union. We have already heard about the complex barter transactions which make the cost of doing business very high.

They have removed virtually all of their quantitative restrictions on imports so they are now basically an open market, not only to the benefit of exports, but to the benefit of their own market by putting competitive pressures on their enterprises that did not exist before.

They have adopted a full range of legal reform. They have reformed the foreign exchange law, they have adopted an anti-monopoly law that is actually modeled after our own and the EEC. They revised the foreign investment law; they have at least promised to eliminate certain transitional limitations on repatriation there. They have opened up banking, which is in a very primitive stage in Poland. And they have begun the enormous task of privatizing the 70 percent of the industry which is controlled by the state.

In that sense, Poland has put together and started a reform program that would lead it to a market economy. The rest of the countries we are talking about are discussing these things but they just have not taken the hard steps.

The results have been fairly dramatic. The stabilization program which was put in at the same time has controlled the hyperinflation. For instance, last October, inflation was in the neighborhood of 600 percent. In the month of February, inflation was down to 4 percent, and I think in March, it is going to be even better.

The other thing that is dramatic to anybody who has spent time in Eastern Europe, and certainly the Soviet Union, is suddenly the shelves are full and there are no lines. It is just hard to explain the difference of being able to walk down the street and someone says it only looks like the High street in a Northwest English, not too prosperous community. That is such an enormous change in the socialist economy you cannot appreciate it.

Senator LIEBERMAN. And is that happening throughout Eastern Europe and the Soviet Union?

Mr. BELL. No. Obviously, Czechoslovakia and Hungary are wealthier countries than Poland, and in that sense, goods have been somewhat more prevalent. But they have not made the switch from a shortage-driven economy where you have lines to an economy that is driven by demand where you do not have lines.

In a demand driven economy, prices are higher. You move way up the demand curve so that less is purchased. It has an enormous impact. Last year there were 6 hour lines at gas stations in Poland. There are no lines at gas stations in Poland anymore. There are less people driving, but the market is working.

However, we are at a critical stage. It is very hard to make these adjustments. What people do not realize or like to realize that adjustment is not something that you do in 3 months. These are programs that take several years before you begin to get large investment flows coming back.

But the political pressures, which I am sure you will understand, are enormous in this type of situation to begin re-inflating. And that, of course, will be extraordinarily dangerous. That is what does happen in Argentina and Latin America. They have 2 months of reform and then they have 7 months of chaos.

We are now at a critical period to hold the line. The difficulty is that most Polish enterprises have not had any experience in dealing with the market economy. They have some advantage. Agriculture, at one level, has always had a free sector, and many small businesses, interestingly, are springing up. Sales out of cars, in competition with the existing distribution system, are made all over the place.

Last week when I was in Poland, I went by one market that was composed of entirely private merchants selling out of cars produce brought in from Germany and other places in competition with the official distribution channels, channels which are notoriously inefficient.

Nevertheless, we have got 7,000 enterprises in Poland under severe stress, and one of the things that we could do that would be extraordinarily helpful right now, is to provide management expertise. This could be provided particularly by small businesses and groups in the United States to these entities.

Polish businesses do not know how to find the market. We talk about small businesses here having trouble finding markets. You talk to a Polish businessman, they do not have any idea how you find that market in the West, even when they have a product to sell.

Senator LIEBERMAN. You are not talking about finding that market in Poland, finding a market in the West?

Mr. BELL. Even finding a market in the West. In Poland you know they are a little better, but exports, after all, become critical in this situation.

Senator LIEBERMAN. What is your sense of how much we are doing now?

Mr. BELL. Well, there is——

Senator LIEBERMAN. We, the American Government, American business?

Mr. BELL. Well, there is indeed one bill, a certain amount of technical assistance is being provided But you know it is typically by these sort of missions approach and so forth. What we need is support—really a manager in every enterprise. That exaggerates it, but only slightly.

Some of the people with whom I work have recently had an American management advisor visit a number of Polish firms. And in many of these firms, there are things that can be done by changing inputs, by getting rid of operations. Typically, in socialist economies they are integrated vertically far too much.

And while General Electric has 70 percent or 60 percent of small businesses providing parts, in Poland somebody producing an engine will integrate backward. Each one of the suppliers is part of the total organization and it is very inefficient.

The Poles need to know how to spin those operations off, get rid of those parts of their activity that do not work. But if it is done, and done promptly, many of these enterprises can survive either in a domestic market or in the foreign market.

And I think, frankly, it is going to be critical to the success—or maybe critical to the success of the Polish experiment, because if businesses start to fail in substantial numbers, which is quite possible right now, the pressures politically will be overwhelming and at some point, if the pressures become too great, then reform will not go forward.

This requires action now. It is not something that can be done in fiscal year 1991.

Senator LIEBERMAN. I have a provision in the bill I introduced that tries to provide American Government financing for the training of Eastern European business people. This is done by either bringing people over here for short periods of time or by sending American business people over there to train them. I think the more we hear about the need for this, the more critical it is.

I would like to share an anecdote. I visited the International Executive Service Corps, which is headquartered in Connecticut. They send retired executives from around the country to various parts of the world. There was a gentleman who was a former executive of the Ethan-Allen Furniture Company. I think he was from Massachusetts or Maine. I have forgotten. But anyway, he had been sent to Poland, I believe—it was Poland or Hungary—to go to a furniture factory for a period of time.

And he said that when he went to the factory, he was tremendously impressed by the quality of their machinery and by the quality of their product. He said, why do you need me? Well, we do not know how to sell our product. I mean, they did not know how to market. And he developed a marketing plan for them, much to his satisfaction and theirs.

Mr. **Bell.** That is frequently critical. I had one academic friend that suggested the best thing we could do is parachute in 1,000 brokers immediately.

Senator **Lieberman.** Well, there are some available on Wall Street. [Laughter.]

Mr. **Bell.** Unfortunately, Wall Street brokers, even now, have not learned that when you have excess supply, price needs to come down. [Laughter.]

The rest of my remarks are in the record. I would like to just say one brief word about the Ukraine. When you go to some of the Soviet entities there, you know they are stages, of course, behind where Eastern Europe is in terms of understanding these problems. And we have just an enormous effort there for basic education and information.

There are few economists who understand markets, and there are some businessmen who understand how to do deals. As a matter of fact I meet a lot of businessmen who understand how to do deals, but at the level of the population and at the level of general market understanding, it is really necessary to do a serious educational effort.

There is a great deal to be done, and we are trying to do some of that through academic groups. It is important in order to prepare the ground for Soviet economic reform. If we believe the papers in the last couple of days, they are now taking a very close look at the kind of Polish dramatic approach. Before that can be successful, however, much basic work must be done.

[The prepared statement of Mr. Bell follows:]

Testimony of

Joseph C. Bell

HOGAN & HARTSON *]

Before The Senate Committee on Small Business

March 23, 1990

Thank you Senator Lieberman and other distinguished members of this Committee for giving me the opportunity to speak to you today. There can be little doubt that you are addressing one of the most important economic and political issues facing the world today. The United States can play a central role in the efforts of these countries to establish viable market systems, but the United States can do this only if it is willing to commit significant private and public resources.

In reviewing developments in Eastern Europe, I would like to limit my remarks to Poland and the Ukraine, the two areas of Eastern Europe with which I am personally acquainted. These two areas are, of course, in vastly different stages of development. But both present important challenges for American foreign economic policy and American businesses. American technical assistance, especially to enterprise management, may be critical

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*] Hogan & Hartson, is retained by the Finance Ministry of the Government of Poland and is registered under FARA. These remarks, however, are solely my personal views.

to the success of Poland's economic revolution and to the preparation for a similar revolution in the Soviet Union. Small businesses with their wealth of managerial acumen could play an important commercial and technical role, but to do so they must understand the opportunities and cultures within which they must work.

The dramatic events of this last year, as one country after another cast off the Soviet imposed political systems, have been easy to grasp and to celebrate. Almost as important and much more difficult to understand, however, are the enormous economic transformations these countries are also initiating.

Poland is, in this respect, by far the leader. Since the new government of Prime Minister Mazowiecki was installed, Poland has begun one of the most fundamental economic changes ever attempted. Simultaneously, it has engaged in both a major stabilization program and a complete restructuring of its economy to move to a Western-style market economy.

Since January 1, 1990 the government has:

-- Eliminated virtually all price controls and abolished the central allocation of inputs, exports and imports.

-- Opened the economy by removing virtually all quantitative and licensing restrictions on foreign trade, replacing them with uniform and generally-low tariffs.

-- Established "internal" convertibility for its currency, as an essential step in permitting the free movement of exports and imports. Poland is the first Eastern European country to make its currency convertible.

-- Reformed its foreign exchange laws, adopted an anti-monopoly law modeled after our own and that of the European Community, revised its foreign investment law, reformed its banking laws to encourage private banking, and, in general, opened up the economy.

-- Begun to adopt laws to privatize the 70 percent of the economy still in state hands, an enormous and complicated task.

At the same time, to bring under control an inflation of over 800 percent last year, the country adopted very tight fiscal and monetary policies creating positive interest rates and virtually eliminating the budget deficit. This removal of the "soft budget" constraint in which state enterprises could depend upon state credit to bail them out of their inefficiencies, has been a critical step.

The results have been dramatic. The inflation rate for the end of the month of January to the end of the month of February was approximately 4 percent; this compares to the monthly inflation rate in October of 600 percent. Shortages of consumer goods have been virtually eliminated, and with them the lines that are the hallmark of socialist economies. Exports and imports are up.

Perhaps the highest tribute to this success is the reported comments of Professor Nickolai Petrokov, Gorbachev's new principal economic advisor, and the study group he is leading. After declaring that the current programs were complete failures, the group was reported to have said that the Soviet Union should engage in massive shock reform of the Polish model.

The Poles have accepted enormous personal sacrifices to make these changes. Industrial output has declined by 30 percent and unemployment has risen to one percent, and is expected to rise further. While small by our standards, unemployment has previously been unheard of. We can compare their acceptance of a 30 percent fall in output to the few-percent decrease in personal income it would take us to balance the federal budget immediately to understand the sacrifice that the Poles are willing to make now, in order to have a better life in the future. When it comes to fiscal discipline, we could learn a lot from their commitment.

- Now is a critical period in the Polish economy. With the initial hyper-inflation under control, there are increasing pressures to begin relaxing the strict regime. As experience in Latin America shows, this would be a fatal mistake. After such a promising start, it would be a tragedy for Poland to become a borsh-belt Argentina.

There is a way, however, to ease the adjustment without undercutting the stabilization program. What is needed immediately is a program to provide technical managerial assistance to assist individual Polish firms in making the transition to a free market.

In socialist economies most "managers" were engineers since the only variations that they were able to control were technical, prices and output being fixed. Further in an economy of shortages every firm had incentives to integrate vertically to assure the supplies it needed. In the most famous case during one period of shortage the railroad was supposed to maintain its own pigs to feed its employees.

Now suddenly new skills are needed, yet these enterprises know very little about acquiring components at the lowest price or marketing its product, let alone reorienting its labor patterns of use. Here is where American businesses can help. They have that management expertise, and the most modest assistance could have enormous impact. But the assistance is needed now. A particularly-critical sector is banking which although now open, is still in a very early stage of development.

If too many firms begin to go bankrupt, not because they inevitably must, but because there was no one to help them in the short-run, it is possible that the whole reform effort could be brought down. The consequences could be devastating for us and for the Poles. We must provide aid immediately with both official funds and volunteer efforts.

I would like to turn briefly to the Ukraine. There, of course, the situation is far different. The economic system is on the edge of collapse, and probably would collapse if it were not for the unofficial market. Shortages are everywhere: fruits and vegetables and, let alone, luxuries like flowers,so abundant in Poland, are virtually non-existent except at enormous cost on the black market.

Yet here there too are strong forces for change. Economic experiments, some recognized and some not recognized, are taking place. Cooperatives and others have tried to create a few Western-style businesses and banks and I have met numerous entrepreneurial individuals during my work there. To take just one example, a new cooperative bank has received several hundred million rubles of credits in its first year, and it is using those deposits like a real bank seeking out good credit risks and lending where real opportunities exist.

I have also met with young entrepreneurs having ideas and inventions to sell to the West. Some of these efforts may make sense and some may not, but the point is that among all the greyness there are many imaginative people who want to have a better Western life. This has been graphically demonstrated in recent city elections where the non-communist parties gained control of Kiev and where the share of such parties in the Ukranian Congress has greatly increased. Rurk, a group of intellectuals, which made sizeable gains in the recent elections has specifically adopted the goal of establishing a market economy.

Unlike the Poles, however, very few people in the Ukraine have been really exposed to Western economic thinkers. After all, in Poland agriculture was never collectivized, and there was always much greater access to Western ideas and thinking. Yet the Ukraine has a population the size of France and contributes 25 percent of the Soviet Union's output. There is, however, an enormous lack of understanding among most people, including professional economists about how a market system actually works.

Partially, it is just a matter of contact. Frequently, I am the first American lawyer that a Ukranian has met. There is much focus on Moscow and now on the Baltic republics, but much less on the other Republics. In an effort to remedy this, a coalition of the City of Kiev, the academies there and a number of leading enterprises approached me and others to provide Western assistance to match their own research efforts on implementing radical economic reform. In response I am working with Professor Hogan of the Kennedy School at Harvard and Professor Hansmann at the Yale Law School to lead a group of American and other Western academics to provide assistance and critiques of their work. As part of this program we will have law students and graduate students in Kiev this summer.

There has been much debate recently about what the United States should do with respect to economic assistance for the Soviets. Without trying to answer that larger debate, my limited experience suggests two clear points: first, until there are major and fundamental reforms, there can be no sense in providing the Soviets with any massive economic assistance other than emergency-type relief. Without a basic change in the system, the assistance would simply be wasted. Interestingly, this seems to be the verdict of Professor Petrolov.

At the same time I think that general education and technical assistance to enterprises, just as in Poland, would be very helpful in promoting radical change and in making such changes successful once initiated. It is enormously valuable to expose as many Soviets as possible to the concepts and ideas of market economies and how they work, and to initiate as much professional and popular discussion as possible about what is required.

Unless a real basis for understanding is created, it will be very difficult for the Soviets, the Ukrainians or any other Republic to initiate truly effective reform. We have a great interest in the Soviets successfully joining the Western economic system, but just the intellectual distance they have to go, let alone the practical steps they have to take is stutpifying. Yet as 1989 has shown, much that was thought to be impossible has already occurred.

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Senator **Lieberman**. I thank you. Let me just ask each of you a few questions in the time remaining. One of the things that I know business depends on here, and certainly for foreign investments, is predictability. One of the questions that we in the Congress have been asking ourselves is are the changes that have occurred in Eastern Europe reversible?

And I wonder from a business point of view—three of you have invested, and, Mr. Bell, you have worked there—whether you feel that there is sufficient predictability for American business to invest and does that vary from country to country?

Mr. Doyle.

Mr. **Doyle**. I think to answer your last question, Senator, I think there is a mistake if we lump all of the Eastern Bloc nations together. And I think you do have to take it country by country. At least we have concluded that there is sufficient predictability to make investments.

Having said that, I will also point out that we seek and obtain, wherever we can, OPIC insurance, and the like, to protect those investments and try to enter into the kind of contracts that allow us to perhaps rescue something if we need to rescue it.

But our fundamental assumption is that there is sufficient predictability to justify investment in those countries. And the insurance equation is one that is obviously very helpful, and the more we invest I think the more predictable it becomes.

I would make one other comment in echoing, I think, several of the other panelists, and that is, as you know, I was part of a Department of Labor Advisory Task Force on this whole question of changing the structure of work in the emerging nations, particularly in Hungary and Poland. And if there is a risk, it is that we do not manage or they do not manage that process in a humane and thoughtful way; if there are enormous worker displacements occurring, then you are going to get political backlash.

And that is where I think American expertise, the development of supplier networks, which are critical, and small business contribution to that kind of effort is going to be perhaps the most important determinant of whether or not economic liberalization continues or stops.

Senator **Lieberman**. Is it your sense so far that they are managing the situation? Of course, some of those dislocations are just beginning to occur, so it is too early to say how they are managing them.

Mr. **Doyle**. And part of the problem, of course, is—like any other systems problem, wherever you start seems to be the wrong place. But you get to—there is enormous need in Hungary, for example—enormous need for housing, which is a small business kind of activity. There is an enormous need for supplier networks. I think the point was made about overly integrated operations, so the need is there. How to convert that need into a meaningful market requires us to both, I think, fund small businesses and to then help them specifically on how you do that.

Senator **Lieberman**. Dr. von Braun, Mr. Madara, do you want to respond to the question about predictability and which countries you think American business would do best to move into first?

Mr. **Madara**. Well, I think that, no matter where you are dealing, whether it is the Soviet Union or Latin America or anywhere, the predictability question comes up. And you have to look at it in two ways. First of all, the stability of the Government and where it is going, you make one analysis.

But any business worthy of doing business outside the United States has to structure its transactions so that it is always in a positive cash flow, it always has its costs covered. You invest the minimum necessary. You try to use—if the OPIC Insurance is available, that would be wonderful. That sort of thing.

With respect to the Soviet Union, we have had a number of talks with very high level officials in the Soviet Union, the Congress of People's Deputies, and the Supreme Soviet. And the question has always been, after Gorbachev what, or is there going to be an after Gorbachev, is he going to be taken out of power.

And the general—I guess the consensus we have got is Gorbachev is in for the long term. The process of restructuring the economy is so far along now and has filtered down so far to the average Soviet citizen that, while the Soviets do not particularly like Gorbachev—the man in the street—and their standard of living in fact has gone down—there are fewer goods on the shelves, there are longer lines at the gas pump and there is more grumbling and that sort of thing—they realize that in the long term they will be better off.

So the opposition to Gorbachev, the very conservative block, is not well organized enough. And second, it does not have anyone that they could put up. But even if they were well organized and were able to put someone up as a rival to Gorbachev, they could not turn the process around.

So we think in the Soviet Union predictability is as predictable as you are going to get, but is not an unreasonable risk to go in there, especially if you structure it right. And we feel the same way—Czechoslovakia and Hungary are not under—they are not swamped with huge foreign debt. Those countries have a much greater chance, it seems to us.

Poland has an enormous debt. That is a real problem. Romania is another real problem area. Yugoslavia could break up into five nations tomorrow. So if you know you are going into a market that could Balkanize over night, you structure the transaction properly. But it would be helpful if we had OPIC Insurance—we could put a little more in. And the more we put in the more predictable the market will be because it becomes more like us.

Senator **Lieberman**. I think you have both made a very good point that this is a self-fulfilling prophecy. That is, the more risk is taken, hopefully an insured risk, the less risky the whole operation becomes.

Peter.

Dr. **von Braun**. I would be wasting your time by restating the case that was made quite cogently.

Senator **Lieberman**. I would be interested to have you talk about your experience for the record. I know when we talked about your computer joint venture, you indicated to me how you had dealt with the problem of convertibility of the currency. And just for the record, I would like to hear you describe that here.

Dr. von Braun. We started from the point of view that we had to find—to find new sources of foreign currency or countertrade in order to do the business at all. And the reasons that we won against 17 competitors from eight countries was because we applied an enormous amount of our effort toward solving that foreign trade problem for the Soviets.

Senator Lieberman. In a sense, you dealt with the credit problem better than anyone else did, but in a different way.

Dr. von Braun. Because we provided a mechanism for the Soviets to pay us in cash. The stories about countertrade are legion. The first commodity that they offered us was stuffed wolves.

Senator Lieberman. Stuffed wolves? [Laughter.]

Dr. von Braun. Have you any idea what the Sierra Club would have done to me if we had done that? [Laughter.]

And the company happened to, at that point, be located in Southern California. That would have been the only issue which would have united the John Birch Society and the Sierra Club. We were selling technology to the communists and wiping out the Siberian wolves. [Laughter.]

Senator Lieberman. What was there second offer?

Dr. von Braun. It was not much better. We, however, found a technology owned by a small business in the United States—in Texas—that will allow the Soviets to recover an incremental 30 percent of their unrecoverable oil resources. And that should generate on the order of $5 billion to $10 billion of hard currency a year.

And by introducing—we used technology to solve our problem.

Senator Lieberman. To create some hard currency for them which they can now use to pay you.

Dr. von Braun. Right.

Senator Lieberman. Would you have gone for Ex-Im Bank financing if that were easily available? Would that have made——

Dr. von Braun. It would not have covered the magnitude of the transaction that we had negotiated. We would need—again if you go back to the basic issue or observation that the Soviet Union and some of the other Eastern European countries will buy anything you can pay for. I was not facetious about that. The internal demand there is so huge.

For example, the Soviet Union must build a modern telecommunications system. AT&T, if you take all of the R boxes, the Baby Bells and fold them all together, the total investment in our telecommunications system is probably $500 billion.

Now Ex-Im financing is not going to deal with that. They have to build a viable economy to support their people to create a gross national product with disposable income, which will make them a viable trading partner.

Senator Lieberman. Mr. Doyle.

Mr. Doyle. I would raise only one concern, and that is that I do not think we can view barter arrangements as a reasonable substitute for credit in the long term. It is a very expensive way of doing business.

We are, I think, the largest nonJapanese trading company in the world. And we use it to do business everywhere in the world. But it is an added transaction cost, and if you are going head to head on an equivalent basis with someone who does have credit availability, you lose those orders.

Now, when you are competing with others who perhaps cannot move as quickly on that, then we do exactly what Mr. von Braun's company did very successfully. And we have done it a lot, and all of our competitors have. But I do not think it can be viewed as a kind of easy, private sector alternative to Government financing, as long as the Japanese and Western Europeans are providing it.

Senator LIEBERMAN. Does he have a point though that in the case of that transaction, which ultimately is a pretty big one, that it might have been beyond the Ex-Im Bank's capacity to finance?

Mr. DOYLE. Oh, yes.

Senator LIEBERMAN. What are his alternatives then?

Mr. DOYLE. Almost every transaction I think is a multi-layered transaction. It is company risk. It is Ex-Im financing. It is bartering. And you eventually build up to the level of ability to participate. And if you give away any element of that, you are not in the game.

Senator LIEBERMAN. I thank you all. We have to move on to the last panel. You have been extraordinarily helpful, and I hope that we will keep in touch as we continue with our work on this issue. Thank you very much.

I call the third panel now, which is Keith Crane, of the RAND Corp., Dr. Paul Welfens, of the American Institute for Contemporary German Studies and Sarah Carey, who is an attorney with Steptoe & Johnson.

Good morning. Thank you for your appearance. Thank you for your patience.

Sometimes when I go through these hearings, I think we should start with—we should put the Government witnesses last, instead of first to let them respond, but here we are.

I will begin with Dr. Crane from the RAND Corp.

STATEMENT OF DR. KEITH WILLIAM CRANE, ECONOMIST, THE RAND CORP.

Dr. CRANE. Thank you for inviting me to testify for the committee.

I would like to confine my remarks to three subject areas: One, reform and economic problems in Eastern Europe; second, business opportunities there, particularly for small business; and third potential U.S. policies, first to assist U.S. firms in interacting and participating in the changes in Eastern Europe and the economic opportunities there and then, second, to facilitate the transition from central planning to markets.

In my written testimony, I went country by country. I would like to focus just on a few common problems and policies that I see throughout the region, the most important one being the transition to market economies, which all these countries, maybe with the exception of Bulgaria and Romania at this point, are attempting to undertake.

It is true that all the East European countries suffer from the legacies of their Socialist past. They have problems with environmental degradation, an obsolete capital stock, both technologically and, in many cases, physically. Poland, Hungary, and Bulgaria all have hard currency debt problems. These are going to burden the new governments. They are not starting with a clean slate.

But the real key, of course, is the whole process of transition occurring right now. Once this transition is undertaken, there is really no reason why these countries should not be as rich as their West European counterparts. The long term is quite bullish, but the hard part is right now.

Senator **Lieberman**. Bullish because of the essential resources in the markets?

Dr. **Crane**. Because of the human resources. Any country in the world with market economies, sensible macro policies, and a well-educated labor force has done very well.

Senator **Lieberman**. And they have it?

Dr. **Crane**. Well, they do not have the policies yet.

Senator **Lieberman**. What you are saying is that they have the potential for a well-educated labor force.

Dr. **Crane**. The labor force is there and willing to go to work. In fact, we have a pretty good idea of what types of policies will get them there, which are fairly straightforward. Price liberalization, trade liberalization. I think sometimes we forget in the States that the purpose of trade liberalization is to help yourself, not the other guy, and that lowering import tariffs helps yourself. That is the whole purpose of it.

Unfortunately, there are some painful parts to this process of restructuring. First in trade liberalization, as soon as you open up those very high barriers to trade which you see there, you are going to see a big influx of imports, and unfortunately, the supply side is not flexible enough to start generating the exports which they need to balance their current accounts.

So the likely result is going to be a fairly drastic devaluation, which leads to declines in living standards. This is an area where possibly, U.S. Government and international organizations can help by cushioning the shock.

The other major problem, however, is privatization, which Hungary and Poland are pushing most rapidly. The problem in Eastern Europe is there is no owner right now. Nobody uses the existing capital stock efficiently. They are not trying to maximize profits, and as a consequence, the countries are poor. They are wasting a lot of their existing assets, and nobody is doing a very good job of figuring out where to put financial resources. They invest a lot of what they produce, but they invest it very poorly.

The solution, as recognized in Eastern Europe, is to get the Government out of the decision process of deciding where to invest and get rid of its position as owner.

The problem is how do you get there from here. Some people have talked about employee stock ownership options. Other's talk about the creation of national trusts, giving all assets to a national trust. The Government would then give shares in the national trust to everyone. Others have looked at privatization by—particularly for small businesses—giving companies to the workers. This is an area where the real danger politically is that the process seems to be unfair, certain groups having better access, other people not being permitted to partake.

There is another big problem next year, which they face during this process, and that is a collapse in Soviet trade. You are very familiar with Soviet problems. On top of the collapse of the Soviet market there is also going to be a change in the way they trade with Eastern Europe. Right now it is more or less barter, they give the Eastern Europeans a fairly good deal on machinery trade. Next year, it looks like they will be trading in hard currency at world market prices. As a result, East Europeans will have to export more machinery or other goods for the same amount of imports, and they will also see a collapse in Soviet demand. This could cost them somewhere on the order of $1 billion or more per country.

What are the opportunities for U.S. business? A lot of the investments which would probably be most beneficial and most profitable are those that are at a small level. Much of the investments at this date in Poland and Hungary have been made by small U.S. businesses, focusing on niches and trying to look at particular small parts of the market.

One warning I would have for U.S. businesses is that right now there are tremendous opportunities for profits because of the process of change and transition in the price structure. Certain areas look very profitable today, but those profits will disappear very quickly, as the countries become more market oriented, and as they end up with a more traditional market system.

The focus then should really be on areas which look like they will be profitable in the long term, not just a one-off possibility of getting quite high profits.

Eastern Europe has a number of very protected outmoded sectors, especially in telecommunications, computers and motor vehicles. With the change in trade with the Soviet Union, those countries will now have to compete on the Soviet market on the same basis as firms in the West, including those in the United States. Here there is a tremendous opportunity both to export to Eastern Europe in these areas and also to exhort to the Soviet market on a more even basis than the United States has faced in the past.

What can the U.S. Government do to facilitate U.S. business opportunities? I would say one of the most important things is to revise—drastically revise the current policy on controls on technology transfer.

Eastern Europe, especially as those countries alter their security arrangements with the Soviet Union and move toward democracy, should be given the same access to U.S. technology as other neutral states, such as Austria and Finland. If the countries are willing to give guarantees of not transferring technology to the Soviet Union, and move toward markets and democracy, the United States should negotiate treaties with these countries like those we have with Austria and Sweden, providing them the same access to technologies as Western countries have today.

The second thing that the United States should do is to drop these countries from the designated country list, again, as they alter their security relationships with the Soviet Union. The United States should focus on preventing Technology Transfer, not by focusing on nations but focusing on individuals and companies like we do in regulating Technology Transfer from the United States to West Germany.

Finally, I think it is important to relax visa requirements so that there is an easier and greater flow of people.

To conclude, I would be wary of trying to solve East European problems with massive flows of resources. But problems are going to be important for three of the countries—Hungary, Poland, and Bulgaria—but not for all of them. These are probably best handled through the IMF and World Bank. The United States can probably most profitably concentrate its resources on creating a regulatory environment where U.S. businesses can invest in trade with Eastern Europe on a private basis.

[The prepared statement of Dr. Crane follows:]

STATEMENT OF KEITH WILLIAM CRANE*

before the

Senate Committee on Small Business

March 23, 1990

INTRODUCTION

Mr. Chairman and members of the Committee, I would like to express my appreciation for the opportunity to appear before this committee and to comment on the subject of U.S. trade and economic relations with Eastern Europe with which you are concerned.

My testimony will be divided into three sections: 1) Reform and economic performance in Eastern Europe, 2) U.S. business opportunities there, and 3) potential U.S. policy initiatives to facilitate the transition from centrally-planned to market economies and to assist U.S. firms in participating in the emerging business opportunities.

REFORM AND ECONOMIC PERFORMANCE IN EASTERN EUROPE

The economies of Eastern Europe are in various states of disarray and the new leaderships are of various minds concerning the appropriate policies to improve economic performance. However, each new government will be confronting many of the same problems as they develop new economic systems and policies.

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The Flaws of Centrally-Planned Systems

In the old centrally-planned systems the Communist Party leaderships and bureaucracies, not markets, determined the allocation of resources. They decided upon the most important investment projects, rough targets for output among the various industries, and trade flows with the other members of the Council of Mutual Economic Assistance (CMEA), the economic arm of the Soviet Bloc. They enforced their decisions by tying bonuses and promotions to the fulfillment of plan targets and responsiveness to their personal requests, by controlling the allocation of industrial inputs through the state wholesaling organizations, and through the state monopoly on foreign trade.

Because the old systems were incapable of efficiently allocating capital and labor, productivity growth has been very low. In some cases capital productivity has fallen. Tight controls on private entrepreneurs and disincentives for risktaking in state-owned industry have led to very low rates of innovation. Because of tight controls on imports and exports, firms have faced little competition on the domestic market so there has been no push to improve quality or lower prices. Moreover, enterprises often cannot obtain key, high quality components needed to make manufactured goods competitive on world markets.

The result of these policies has been to keep the citizens of Eastern Europe and the Soviet Union much poorer than their similarly educated counterparts living in market economies. The very large disparities in living standards between East and West Germany or Czechoslovakia and Austria, countries with similar economic, educational and cultural heritages, helped topple the old regimes. The task of the new regimes throughout Eastern Europe will be to make substantial progress in closing these gaps.

New Economic Policies

The new, generally interim, leaderships have proffered a variety of solutions to these problems from the radical move to capitalism taking place in Poland to the maintenance of central planning in Romania. Although the legacy of forty years of socialism which includes high levels of foreign debt, severe environmental problems and an obsolete capital stock, will retard economic growth, the economic policies pursued by these countries will be the primary factor determining whether they succeed in rapidly increasing factor productivity and standards of living. Because of the importance of the new policies I would like to focus first on their nature and prospects for their success.

Poland. To date, Poland has launched the most ambitious policies of reform. The initial policy goals have been to curb dramatically the rate of inflation and to begin the process of restructuring the economy.

Poland's program, designed by Deputy Prime Minister Leszek Balcerowicz, seeks to halt inflation by liberalizing prices, pegging the zloty to the dollar, and sharply reducing the budget deficit--primarily by cutting subsidies. These measures were introduced simultaneously at the turn of the year. The plan has been very successful to this point. After reporting a rate of inflation of 100 per cent in January inflation fell to less than 10 percent in February and should decline to West European levels by spring. The cost has been a decline in production of 10 percent in January. Although statistics show unemployment is still less than one percent of the labor force (150,000 people), the number of jobs available has declined dramatically and the number of people looking for work has surged so the trend is towards large increases in unemployment.

The second stage of the program is designed to create a modern, market economy in Poland. The government is designing a program to sell off state-owned enterprises to the private sector. It is also breaking up state-owned monopolies and lowering barriers to entry for small enterprises and encouraging foreign investment.

The government has been successful in breaking up Polish monopolies, but faces a daunting task in terms of making the Polish economy more elastic. Telephones, office, commercial and manufacturing space and electrical hookups continue to be disbursed administratively. Consequently, it is still quite difficult to set up and expand a business, despite the pro-small business attitude of the government. Because it has been very difficult to buy and sell housing and because the rental market functions poorly, most Poles find it virtually impossible to move from one part of the country to another. Consequently, the labor market is fairly rigid. The capital market is almost nonexistent; private businesses find it very difficult to obtain finance.

The Polish economy is undergoing a difficult process of adjustment. Workers will be changing jobs, obsolete capital stock will be retired and new ways of doing things will be introduced. This said, a number of positive factors exist as well. The Polish economic policy team is excellent. Over the past decade an entrepreneurial class has emerged.

By 1987 private industry already accounted for over 10 percent of industrial employment; Poland currently has some hundreds of thousands of small businesses. The country has a well-educated, well-trained labor force. Most importantly, it has rid itself of an inefficient economic system that has throttled Polish growth for the past four decades. Given proper macroeconomic policies, Poland should generate substantial rates of economic growth.

Hungary. Hungary has also been proceeding quickly towards creating a market economy. However, recent policy has been hampered because it is being run by a lameduck government. Elections, scheduled for March 25, will produce a new, non-Communist government and a new economic policy team.

Hungary introduced a comprehensive economic reform in 1968 that maintained state-ownership, but greatly expanded the freedom of enterprise managers to make their own decisions. It also replaced rewards based on fulfillment of compulsory plan targets with bonuses based on profits. After a retreat from the reform in the mid-1970s, the Hungarian government substantially liberalized trade and restrictions on foreign investment and private enterprise in the 1980s. Prices were linked with world market prices.

Despite these measures, the Hungarian economy is still dominated by large, state-owned enterprises and trade policy remains highly protectionistic, although less so than in the other countries of Eastern Europe. The new government will likely face the problem of more rapidly dismantling barriers to trade while keeping the country solvent and of moving state-owned businesses into the private sector. However, overall the Hungarian economy is in better shape and will probably begin growing more rapidly sooner than the Polish.

The GDR. The German Democratic Republic (GDR) is in the midst of integrating with the Federal Republic of Germany (FRG). With the exception of Romania, the GDR adhered most rigidly to the Stalinist economic model, including Stalin's penchant for distorting statistics. With the crumbling of the Berlin Wall and the free flow of labor and goods between the two Germanies, this system quickly collapsed. Emigration has produced sharp falls in output; by January 1990, industrial output fell to 1985 levels. The East German government has found it impossible to preserve the old, rigid price system. Tax revenues have fallen because of emigration and because East Germans now buy heavily taxed items such as consumer electronics, appliances and clothing in the West while the strain on the budget has increased as both West and East Germans stock up or heavily subsidized products like bread and meat in the East. Market forces have destroyed the old price system.

Two crucial policy decisions will determine the long term economic health of this part of a united Germany, both of which will be made by the West, not the East, German government. The first is the choice of exchange rate for unifying the two currencies. The rate will be determined by administrative fiat. If it is set too high, e.g., at a one-to-one rate, monetary unification could lead to a sharp, one-time rise in the overall price level. If the rate is set too low, say seven to one, the aggregate money supply may contract sharply, leading to a fall in aggregate demand in Germany as a whole and, possibly, a recession.

The second problem will be setting social welfare benefits. Currently, East German workers are far less productive than their West German counterparts. If unemployment benefits are kept substantially lower than market wages and East German workers are not eligible for West German benefits, the region should boom, as West German businesses invest in a low wage, German-speaking region. If they are set above market-clearing wages, investment will be much lower, unemployment high and the east German states will become a permanent burden on the rest of Germany, much as Northern Ireland is on Great Britain. But if this pitfall is avoided, the economic transition should proceed rapidly despite the large investments needed.

Czechoslovakia. After the East Germans with their access to West German resources, many argue the Czechs have the best chance of quickly and successfully moving towards a market economy. Czechoslovakia has had relatively low rates of open inflation, has run a conservative monetary and fiscal policy, and has low levels of foreign debt. It also has a well-educated workforce and a knowledgeable group of economic policymakers.

Unfortunately, Czech policymakers face considerable difficulty in devising a new economic program. Opinion polls show considerable residual support for state-ownership of industry and some other facets of the old system. The new economic leadership is divided: some policymakers wish to push for private enterprise and markets, others still speak in terms of a third economic system, a socialist market economy. Furthermore, Czechoslovakia has yet to adopt market prices. Poland and Hungary have made considerable progress in this regard. If

Czechoslovakia only liberalizes part way, it will be very difficult to maintain macroeconomic balance: low rates of inflation and unemployment and a balanced current account.

Romania. Romanian economic policy planners continue to adhere to traditional economic plans and have argued that decentralization and reorienting investment from the energy and heavy industrial sectors to light industry will solve Romania's economic problems. This approach is unlikely to improve Romania's economic performance.

Bulgaria. Bulgarian economic policymakers have argued for extensive market-oriented reforms. However, they made similar pronouncements under the old regime headed by Todor Zhivkov. Policy statements have yet to become policy actions. Bulgaria's economic prospects also remain clouded because of its close linkages with the failing Soviet economy.

Problems with Moving Toward Markets

Privatization. Possibly the most difficult problem confronting these countries is how to encourage the establishment of the independent producers needed to make a market economy work. Although the debate continues, a gradual consensus is emerging among economists, East and West, that state-owned property must be transferred to the private sector. This is not because state-ownership is intrinsically evil, but because the state is almost always a failure as owner. To make the economy work efficiently, the owner needs to maximize his rate of return on his wealth. This implies maximizing profits by cutting costs and using the existing capital stock as efficiently as possible and investing in the most lucrative areas he can find. The state, by definition, has multiple goals; maximizing profits in state-owned enterprises is only one. Consequently, the state does a poor job of using and allocating capital.

To improve economic welfare, capital must be transferred from the state to other owners and investment decisions determined by market forces. Economists have suggested that enterprises could be privatized through employee stock ownership schemes, worker and management buyouts, the creation of private pension funds that would buy equities from the state, a wholesale distribution of enterprise equity to everyone in society, sales to foreign investors and transfers of equity and national and corporate liabilities to citizens, thereby privatizing foreign debt as well as national assets. Some of these options have already been tried out. For the process to go smoothly, however, voters must perceive privatization as being honest and equitable. Some privatization programs in Hungary and Poland have already been criticized because managers acquired companies for a pittance.

Aside from obvious instances of corruption, the new governments face a dilemma. If markets are to work efficiently, enterprises need to be released from state control as quickly as possible. To maximize the sales value of state-owned enterprises, the governments need to prepare them for the market through careful inventories of assets, reorganization and, in some cases, closing loss-making plants. Thus, these governments face a dilemma: they may opt for speed or maximization of value, but not both. Too much emphasis on speed, and they will face a political backlash as the public perceives assets being sold too cheaply. Too much emphasis on maximizing value and the entire privatization program and hence the whole process of economic liberalization will become bogged down. If they are to achieve either goal, however, they need to encourage as many participants in the bidding as possible. This implies welcoming foreign as well as domestic bidders.

Open Inflation. The change towards markets, sought by or forced upon the domestic governments, disrupts carefully preserved equilibria kept in place through controls on prices, wages, the allocation of goods and foreign trade. As barriers to flows of goods, people and capital have tumbled down, the domestic economies have had to adjust. As shown by the case of the GDR and Hungary, even nominally stable economies quickly deteriorate as citizens take advantage of their new found freedom to engage in arbitrage by buying in one country and selling in another. As all these countries take steps to further liberalize their economies they face severe problems in maintaining tax revenues and curbing expenditures on subsidies. Past East European governments have financed deficits by printing money, thereby generating inflation. As shown by the Polish case, the solution to this problem appears to be a quick move to markets and austere monetary and fiscal policies.

Balance of Payments Control. Liberalization not only forces adjustments in the domestic price and tax systems, it also tends to create balance of payments problems. Because these economies have been so protected, when barriers to travel or imports are relaxed, imports flood in. Consumers substitute higher quality, cheaper imports for uncompetitive domestic products. In market economies the economy would adjust through a devaluation. Imports would become relatively more expensive, so the quantity demanded declines. Exports become more profitable, so export production increases. However, to this point East European exporters have been slow to respond to devaluations because of supply side rigidities. Governments may respond to these balance of payments problems by borrowing from abroad to cover the trade deficit, devaluing the currency, which often leads to a sharp decline in real incomes, or reimposing controls. None of these options are very palatable, but, in different combinations, they are likely to be features of economic policy in the next few years.

The Collapse of Soviet Trade

To compound these internal problems of liberalization, the East Europeans are facing the collapse of their most important external market: the Soviet Union. They are also finding that their other main trading partners, each other, are sharply reducing demand for their exports. In addition, the Soviet Union has been cutting its subsidized oil exports. These changes impose substantial economic costs on all these countries.

In addition to the fall in demand, the East Europeans are facing a dramatic deterioration in their terms of trade with the Soviet Union. Currently, prices in trade within the Council for Mutual Economic Assistance (CMEA), the East Bloc equivalent to the European Community, are set on the basis of five year moving averages of world market prices. Because it is difficult to agree on appropriate world market prices for manufactured goods, in practice these prices have been set through bureaucratic bargaining. Prices for machinery, in particular, have been inflated through this process. Because the East Europeans are net exporters of machinery to the Soviet Union and the Soviets net exporters of energy (where prices have more faithfully followed world market trends), the East Europeans have received a substantial implicit subsidy from the Soviets: They receive more petroleum for their exports of machinery than they would if they sold these goods on the world market.

At the last session of the CMEA, held in Sofia, Bulgaria in January, the Soviets and the East Europeans advocated changing from trading in transferable rubles using bureaucratically determined prices to convertible currencies using world market prices. This change will force East European firms to become more competitive as they will no longer have easy access to the Soviet market, and make the region a more attractive place for foreign investment because exports to all countries, not just the West, will generate convertible currency. It will also eliminate the terms of trade windfall they have been receiving from the Soviet Union. The change will probably take place as of January 1, 1991.

The Hungarians estimate their cost of moving to world market prices in convertible currencies with the Soviet Union at $500 million to $1,500 million. I have attempted to make similar estimates for the rest of the East European countries based on the value of their net trade with the Soviet Union in machinery plus the same value in energy trade (Table 1). The cost of adjusting to this new trading regime are very large, on the order of twenty or more percent of current hard currency export earnings. This adjustment will impose a substituted additional burden on the East European countries precisely at a time when they are moving to market systems.

Table 1

"Potential Costs of Switching to Trade in Convertible Currencies"

	Low Estimates	High Estimates	As a Percent of Machinery Exports* Low	High
Hungary	500	1500	12.6%	37.7%
Bulgaria	659	1976	10.9%	32.6%
Czechoslovakia	912	2737	14.5%	43.5%
GDR	945	2834	13.0%	39.1%
Poland	654	1963	12.2%	36.5%
Romania	251	753	13.2%	39.7%
Total	3921	11763	12.7%	38.1%

*Converted at the official ruble/dollar rate of exchange.

Hard Currency Debts

Aside from their trade problems with the Soviet Union, a number of countries in Eastern Europe face problems with their convertible currency debts. However, the picture varies dramatically from country to country.

Poland's gross debt, mostly held by public lenders, currently totals about $40 billion. Poland has gone through numerous debt reschedulings and is now seeking forgiveness of a substantial share of the debt. Poland's debt problems have made it difficult to attract foreign investors and have directed attention from reforming the domestic economy to hammering out rescheduling agreements with Western banks and governments.

Hungary faces a severe liquidity crisis this year, but has maintained its creditworthiness. Because of its credit record, Hungary has found it easier to attract direct foreign investment and has obtained lower interest spreads on its loans. However, the sharp squeeze on domestic demand needed to service its debt has compounded Hungary's problems in reforming and liberalizing its economy. Its substantial convertible currency debt and subsequent balance of payments problems will severely constrain the new government's freedom of maneuver.

Bulgaria's debt, mostly commercial, has risen sharply in recent years and Western banks are concerned about its ability to service this burden.

The GDR has also seen a dramatic deterioration in its current account. Reserves declined from $9.6 billion to less than $5 billion in the first months of 1990. Monetary union with or provision of loans by the West Germans will probably occur before the country is forced to reschedule.

Czechoslovakia has kept its debt levels low by severely restricting imports. Although it is currently highly creditworthy, if it loosens controls in the transition towards a market economy, its balance of payments could also deteriorate sharply.

Romania has restored its creditworthiness by dint of severely cutting living standards. According to the Romanian authorities, it is now a net creditor to the rest of the world. Thus, the government has some room to relax import curbs as it attempts to raise living standards.

The Environment

Both water and air pollution present daunting challenges to the new East European governments. Silesia (southern Poland), northern Bohemia and the southern parts of the GDR form one of the most polluted areas in the entire world.

The construction of adequate sewage systems and installing emissions controls on factories and other polluters will be a costly undertaking. However, some of the cost of cleaning up pollution will probably be born indirectly as antiquated factories are closed. East European steel producers still often use the open hearth method which contributes greatly to pollution. Poland still has a number of antiquated coke ovens. As these inefficient factories are closed, air and water pollution will be reduced.

OPPORTUNITIES FOR U.S. BUSINESS

Investment

Foreign investment can greatly contribute to successful economic reform in Eastern Europe. A major problem in rapidly creating efficient markets in Eastern Europe is the dearth of small to medium size companies with the managerial, marketing and technological knowhow to take advantage of the emerging business opportunities. U.S. business is well-endowed with these skills. Investment by U.S. businesses, large and small, in Eastern Europe will be highly beneficial to both parties.

In contrast to the Soviet Union, where most investment has been through joint ventures, businesses face a wide number of options in Czechoslovakia, Hungary and Poland. These countries offer foreign investors opportunities for 100 percent ownership and repatriation of profits in convertible currencies. East Germany, especially after the outlines of the unification process become clearer, also promises to be a congenial place for foreign investment.

Most foreign investors in Poland have been setting up small, new firms in which they take 100 percent ownership. These firms, often called *Polonia* enterprises, because they were frequently owned by expatriate Poles, have been a dynamic part of the Polish economy since 1980. Joint ventures in which large Western firms invest with a Polish partner are also becoming more popular. To this point, there have been very few investments in which a Western partner buys all of a large, existing Polish firm.

Hungary has started an aggressive privatization program and has opened up significant opportunities for foreign investors. General Electric, for example, purchased controlling interest in Tungram, a Hungarian light bulb manufacturer. General Motors has announced a joint venture to assemble models produced by its subsidiary, Opel. However, as in Poland, most foreign investment consists of small investments, often on the order of $100,000 to $1,000,000, and often between Hungarian customers or suppliers and their Western partners. Over 1000 ventures were set up in 1989 and Budapest hotels are filled with Western businessmen setting up new deals. A number of U.S. consulting firms and commercial and investment banks have been active in setting up these ventures. As in Poland, U.S. businesses, large and small, are active players, primarily because of ethnic ties.

Czechoslovakia does not have the experience in direct foreign investment of Poland and Hungary. The new government is also less enthusiastic for large scale privatization. However, as in Poland and Hungary, hundreds of West European and U.S. firms are exploring investment possibilities.

Seven months ago the GDR forbade Western direct investment. Now with the imminent prospect of unification, the lameduck government is welcoming investment and West German investors are rapidly purchasing portions of East German industry. Although German investors are overwhelming dominant, the east German market should not be written off by U.S. investors. If wage rates are suitably low, it could be an excellent region from which to export to the European Community.

Trade

The trade liberalization and the move from transferable ruble to convertible currency trade with the Soviet Union create a number of opportunities for U.S. businesses. Many traditional East European products, most notably telecommunications equipment, computers, some motor vehicles (especially trucks), and machine tools, will not be competitive in the face of Western substitutes. For example, the large electronics industries in the GDR and Bulgaria have never succeeded in successfully exporting the the West. Other products such as ships, railway cars, and mechanical components will be more likely to hold their own.

The United States has long had a comparative advantage in producing high technology products such as microchips, computers, telecommunications, etc. There is an enormous demand in Eastern Europe for these goods. All the East European telecommunications companies will have to invest large sums to expand and improve service: Poland, Hungary and Romania have the lowest levels of telephones per hundred households in Europe. Although demand will be constrained by East European capacity to pay for these imports over the next several years, U.S. producers should be able to dramatically increase exports, if they market aggressively.

U.S. POLICY OPTIONS

Technology Transfer Controls

Potential U.S. markets in high technology goods will be throttled, however, if U.S. regulations on exports of technology are not altered. Currently, the East European countries are highly concerned about access to Western technologies covered under the CoCom and U.S. Export Control lists. They believe many of these technologies, especially in computers and telecommunications, are vital for the rejuvenation of their own economies. They see access to these technologies as a testament to their reintegration into Europe and see no reason why they should be denied these technologies. They have dramatically reduced their security ties with the Soviet Union. Hungary and Czechoslovakia, in particular, are actively pushing to leave the Warsaw Pact; Poland has made this a longer term policy goal. As security ties with the Soviet Union weaken or are broken, they do not believe they should be treated any differently than nations such as Austria or Finland. Moreover, they are willing to set up the accounting controls to guarantee that they will not transfer these technologies to the Soviet Union. Because of East European sensitivities to U.S. concerns, the technology leakage that does occur may be substantially less than current leakages from Western Europe or even from the United States itself.

In light of these changes, the United States should remove from the list of "designated countries" those East European nations that successfully install democratic governments and provide assurances that technologies will not be transferred. The U.S. government should control exports to these countries through agreements and treaties similar to those used in trade with Austria and other neutral states. The continued use of special U.S. export controls and embargoing technologies to the emerging democracies in Eastern Europe substantially hampers the ability of U.S. companies to compete in this market.

U.S. Assistance

The most effective form of U.S. assistance will be to facilitate the integration of Eastern Europe into the world economy. Instead of large direct grants to governments or detailed aid programs targeted towards specific sectors, the U.S. government should foster trade, investment, travel and training. Much of this assistance would be regulatory, rather than financial. For example, the U.S. government should ease visa requirements to make it easier for East Europeans to visit the United States, even if they have limited financial resources. It should also ease possibilities for East Europeans to work in the United States so that they can gain experience in how market economies operate. Overseas Private Investment Corporation insurance should be extended to Czechoslovakia and to Romania and Bulgaria as well, if these two countries continue to move towards democracy. Quotas should be expanded or eliminated on textiles and steel. Poland, Hungary and Bulgaria, in particular, face very severe balance of payments problems and will need to have as much freedom as possible to export in the next few years.

Financial assistance can be most useful in sponsoring training programs and providing goods for public institutions such as schools, hospitals and libraries that face very sharp budgetary constraints. Massive public infusions of assistance for particular infrastructure projects such as telecommunications or pollution control would be ill-advised; Eastern Europe lacks the corporate infrastructure to use these funds wisely at this time. For example, investing heavily in telecommunications through the current Polish communications ministry is probably one of the least efficient ways to improve the Polish telephone system.

As noted above, the East European countries face differing problems with their hard currency balance of payments. It may be time to explore more write-offs of Polish debt. Hungary faces severe liquidity problems over the next few years. Western assistance in maintaining Hungarian creditworthiness would be a good investment. It would preserve a rather hospitable climate for foreign direct investment and avoid the possibility of a long, costly session of meetings for a formal rescheduling.

In general, the U.S. government should seek to create avenues for investment. Public sector assistance can best be channeled through international financial institutions. Although East European investment needs are large, the crucial task is to channel this investment to its most productive uses. Funneling it directly through East European government bureaucracies is not the best solution.

The United States can also help the East Europeans by pushing for economic policies that will encourage long run growth. International pressure is often useful for implementing needed, but unpopular economic measures. By adding its pressure to that of sensible economic policymakers, the U.S. government can contribute to trade liberalization, privatization and responsible monetary and fiscal policies, all of which are needed, if Eastern Europe is to grow.

Senator LIEBERMAN. Thank you, that was very helpful.
Ms. CAREY.

STATEMENT OF SARAH C. CAREY, PARTNER, STEPTOE & JOHNSON, WASHINGTON, DC

Ms. CAREY. It is a pleasure to be here. I am not going to repeat any of the comments contained in my written testimony, but I am going to try to make a few observations on the state of the economy in the USSR. My focus is primarily on the USSR, on the opportunities that exist for U.S. companies and what the U.S. Government can do the exploit those opportunities.

Although I am surrounded by experts on this panel, I do not consider myself an expert. I am an attorney in private practice and I spend about 150 percent of my time on U.S./Soviet or East European trade. Our firm has an office in Moscow; the lawyers there work both in Moscow and in Eastern Europe. We have Soviet attorneys as partners, who incidentally are in Washington now for a couple of weeks. But as I say, we are not academic analysts.

You have gotten an accurate impression from the previous witnesses of the changes occurring in the Soviet economy, although they generally get put down as being behind Eastern Europe. These changes already underway in the USSR are truly revolutionary, although because of its size and its resources, it is going to be much more difficult to turn it around.

However, the trend line in the USSR is continuously in the right direction in terms of decentralization, demonopolization, and what they call de-stateization—they cannot quite bring themselves to say privatization.

The series of laws that have been passed already and that are currently under debate, taken together, move toward. these three goals that I just mentioned. The progress is uneven. It is full of zigs and zags, but it is continuous. And from the perspective of U.S. business, it opens up the economy for the first time in almost every sector, putting aside the military.

From a practical perspective, you already had from the previous panel a very clear demonstration that major U.S. corporations do not consider the Soviet market a sufficient risk that it should be avoided. Almost every Fortune 500 company and surely the next layer, lots of smaller businesses, are currently exploring the Soviet market.

In terms of the sectoral opportunities, you have heard mention several times of problems in infrastructure—telecommunications, transportation, housing, and so on. The reverse side of that coin is that it creates tremendous opportunity. There are major deals right now being negotiated between U.S. telecommunications companies and Soviet; the same is true in regard to transportation, including railroads and aviation. Deals are being negotiated in various service sectors that previously were nonexistent or closed to foreigners.

Infrastructure is just one example. In addition, you have openings in many other sectors—energy, health, pharmaceuticals, chemicals, and so on. Food processing, tourism, real estate development, and so forth.

It is very difficult—I think Senator Stevens did a super job—to convey a flavor of the level of business activity being explored between our two countries. I know a lot of the Alaskan companies; it is extraordinary what they have been doing. And that's just a small slice. You can look across the United States and see the same level of interest in State after State and in industry after industry.

The big point, I think, is that the Soviets are rewriting literally every law that affects commercial transactions in a manner that makes doing business there more desirable. They are also changing many of the myths and shibboleths that they were tied to in the past. For example, in the past, they would not allow foreigners to participate in natural resource development. That is changing. Those vast resources of minerals, energy products, even gold, are going to be opened up to foreign development.

The attitude, as I mentioned earlier, of buying services is also radical for them. The Soviets used to subscribe to the ideology that you were doing something useful only if you manufactured a widget. But now they are inviting the insurance industry, accountants and other science companies into the country. I do not know if anybody from Hartford has rushed over, but at least the door is open.

As many of the other witnesses have stressed, this is an area of the world, Eastern Europe too, where Americans are rated No. 1 for a lot of historical reasons. The Poles, for example, would rather have U.S. companies come in and privatize some of their state assets than have the Germans. They had the Germans before and they have uneasy feelings about them. The Soviets do not want the Japanese to come in and colonize the Far East. They would rather have Americans come in and create the development framework and have the Japanese come spend money under the American umbrella. That is pretty unique when you consider the anti-Yankee feeling that exists in other parts of the world.

Since 1985 the Soviets have also been welcoming American expertise, asking companies, lawyers, academics, whoever, to come in and help think through these enormous problems that they are facing.

So, the opportunity is staggering. It has been mentioned before that it is not for the naive or the new-to-export company; it is an opportunity that can be realized effectively primarily by companies that already have a fair amount of international experience under their belts. But we have a lot of those companies in the United State who desperately need, export markets. And in many cases the markets for their products elsewhere in the world are glutted.

What can the U.S. Government do? The first thing the U.S. Government can do is get off the backs of industry. The United States still has a legislative framework that basically puts U.S. companies in an inferior position, vis-a-vis their competitors. The President's commitments at Malta go a long way to redressing that imbalance, but there has got to be very fast movement on those commitments—on the trade agreement, the granting of MFN, the removal of the Stevenson ban on Ex-Im Bank activities, the tax treaty, the bilateral investment protection treaty. Those items are yesterday's agenda, and they have got to be moved fast.

Senator **Lieberman**. That is what you mean by getting the Government off your back?

Ms. **Carey**. Yes. Those are barriers. And I think some bright intern up on the Hill ought to be assigned the task of looking at all the obscure laws and regulations that restrict trade with the Soviet Union. You have got all sorts of obscure restrictions on banking activity that were passed in the Cold War period. We found an A.I.D. regulation that says that A.I.D. financing cannot be available for commodities that contain components from nonfree World countries. We have clients in the fertilizer industry who are very concerned about this. It is absurd. A thorough search of the U.S. Code and regulations, I think, would come up with many such obstacles. And just removing the obstacles would be step No. 1.

The restrictions that export controls play cannot be underestimated. Many companies could tell you horror stories of their experiences with the licensing process that would either make you laugh or cry, depending on your mood at the moment. The current export controls are a major barrier to transactions in the Soviet Union. The implementation, the administration of the licensing process has almost a religious fervor in certain agencies, namely, DTSA. And frequently, the people doing the review process are way behind where the technology is in the United States or in the world.

In any event, the renewal of the Export Administration Act creates a tremendous opportunity for Congress to assert leadership and I am pleased to see that many Members of Congress already are.

There are lots of additional steps the U.S. Government could take. I will just mention them briefly as I see the red light has been on for a couple of minutes.

The expansion of consulates and commercial offices—it is ridiculous for the United States to be in Moscow only. The country is decentralizing. The action is occurring out in many of the republics; the really big opportunities are not in Moscow any more and——

Senator **Lieberman**. Why is that?

Ms. **Carey**. Because the Soviets have told the republics that they are going to let them decide their own fate and there are some leaders out there who have been waiting for that and are pouncing on the opportunity. The laws aren't fully in place yet but the draft laws would give the republics and the cities increased ownership, power over resources, increased taxing power. I mean, the——

Senator **Lieberman**. The economic opportunities may be better there?

Ms. **Carey**. Oh, yes, definitely. The resources are out there and you do not have the big bureaucracies on your back. I mean, it is like Senator Stevens said. They do not recognize Moscow.

The removal of trade barriers and of the limitations on the number of Soviet businessmen that can live here would help. The US Embassy in Moscow, takes the position that they cannot clear a business visa in less than 30 days. The Soviets think they have to retaliate because that has been the old pattern.

You get this drag on businessmen traveling back and forth which consumes all sorts of time, requires consultants to get visas, and so forth. The process should be normalized. As for the Soviets, they cannot open up new business offices in the United States because they can't get residential visas. The United States has put a quota on the number of Soviets that can live here.

Those would be the main points, I also think it is important to make sure that there is a recognition throughout the agencies of the U.S. Government that affect foreign trade that this is the world's most important opening market, that the United States needs to participate in this market for a whole lot of reasons and that the various agencies should do everything they can to facilitate trade.

Most of the companies we work with do not really think of the U.S. Government as helping them. They tend to go in and brief U.S. agencies regarding their activities in the USSR because they think those agencies have the need to know, but they do not really find that they get assistance in furthering their business interests in the Soviet Union.

Senator **LIEBERMAN**. So, it is not just removing those barriers, which are obviously important, but is it attitude or is it just the——

Ms. **CAREY**. It is attitude, resources. The United States, for example, a commercial office in Moscow headed by somebody from the U.S. Commercial Service. That office is like a Soviet office. The equipment is——

Senator **LIEBERMAN**. That is about the worst thing—the room is relatively clear, I think you are safe. We will keep it a secret.

Ms. **CAREY**. The equipment is totally out of date. I mean, it really is Soviet-style equipment. Most of the officials there will spend more time telling you the difficulties of doing business in the Soviet Union and how you are not going to succeed than helping you get to the right place and move quickly. When one watches the British or Canadian offices, they are very different.

The last point is if Congress, and the Senate in particular, could push the President on the economic summit, I think, as one of the witnesses mentioned that, we as a Nation don't take advantage of Presidential exchanges to push United States deals. I mean, Margaret Thatcher never goes to Moscow or sees Gorbachev without shoving at least three British deals down his throat. That is how everybody else does it.

Senator **LEIBERMAN**. Yes, it is an interesting point. I have heard this from companies in Connecticut, not only about Moscow, but about other countries. They feel that they are not only in competition with other companies but the heads of state in which those companies are located.

Ms. **CAREY**. And the other thing is that I do think it is very important, as Gene Madara mentioned, to keep the pressure on the Soviets in terms of the way they implement foreign trade reforms and the way they treat foreign businesses. Their reforms are so immense and so difficult to implement, their legal code cannot possibly be harmonized for at least 5 to 10 years because there is just too much new law.

Implementation of the reforms is very uneven; consequently, companies get treated unfairly. You cannot get coordination among ministries; restraints are put on the activities of joint ventures. There are lots of business problems; the Administration can be extremely helpful, particularly in the context of negotiating a trade agreement, by laying the problems, by and saying? "We want to trade with you, we are going to get rid of Jackson-Vanik and other barriers, but this is what we want you to do." For example, Mr. Madara recommended that the United States demand a certain level of purchases from the United States. This is a good idea but attention should also be focused on reforming business practices. But the United States seized the opportunity created by the summit; that don't happen often.

[The prepared statement of Ms. Carey follows:]

PREPARED STATEMENT OF
SARAH C. CAREY
PARTNER, STEPTOE & JOHNSON
WASHINGTON, D.C.

BEFORE THE COMMITTEE ON SMALL BUSINESS
U.S. SENATE
MARCH 23, 1990

Mr. Chairman, distinguished members of the Senate, thank you for the opportunity to testify. I would like to focus my remarks on US trade policy towards the USSR, although many of my comments also apply to Eastern Europe. My remarks are based on my experience in representing dozens of US corporations in a broad range of industries that are seeking business opportunities in the USSR and Eastern Europe and on my studies of, and travel to, the region. (During the past three years, I have traveled to Moscow five or six times a year and somewhat less frequently to Eastern Europe.)

From a macro perspective, the Soviet economy is performing badly and the Gorbachev era has not brought many visible improvements for the Soviet citizen. However, far reaching economic reforms are being drafted by the Supreme Soviet or have been enacted and are in the process of implementation. The trend line reflected in these reforms is overwhelmingly in the right direction in favor of decentralization, demonopolization and democratization. The Soviets are even beginning to "de-statize" many sectors of the economy. Taking apart the old, centralized command economy and replacing it with more market-oriented systems is causing major dislocations; however, it can be expected that within a few years it will result in greatly improved economic performance.

These economic reforms include: a national commitment to become a full participant in the world bodies that control international trade; abolition of the state's monopoly on foreign trade; permitting direct participation in international markets by all manufacturing concerns -- and a host of other organizations -- in foreign trade; the encouragement of foreign investment in the USSR through joint ventures; the announcement of foreign economic zones where wholly-owned foreign subsidiaries may be created with special privileges; the enactment of a leasing law that permits lessees, including foreigners, to acquire a 50-year or longer leasehold interest in state enterprises, kolkhozes and other property; and the proposed enactment of a host of other laws that will open up the economy. In addition to these specific reforms, Gorbachev and his advisors are attempting to replace the detailed administrative rules that previously directed all aspects of economic activity with general levers, such as tax policy and credit policy to stimulate economic performance. Without going into detail, it is safe to say that in the USSR, virtually every law that impacts commercial activity has been or is being rewritten, generally in a direction that encourages a more market-oriented economy.

In short, the Soviet Union is in the process of an economic revolution that is opening it up to foreign investment. The course of that revolution will not be smooth and, because of the major changes also occurring in the political system, over the near term, the Soviet economy will be characterized by uncertainties and difficulties that challenge the fortitude of the foreign investor.

Despite these problems, it is our prediction that over the next five years both US-Soviet trade levels and Soviet economic performance will increase steadily. The trade figures are already beginning to reverse and many major US companies are in the process of negotiating joint ventures and other transactions that will significantly increase US investment and sales in the USSR. Let me mention briefly areas where our clients are actively negotiating. Although virtually all sectors offer significant opportunities, major opportunities exist in regard to infrastructure construction (transportation, telecommunications, financial and other services, real estate development, including the construction of industrial parks, and so on); natural resources development (energy resources, minerals, timber and forestry products, and fisheries, to name a few); travel and tourism; food production and food processing; the chemical, pharmaceutical and medical industries; capital goods, and environmental products and services. [Attached is an article I recently wrote for Columbia University's Harriman Institute with more details on investment opportunities in the USSR.]

Stated simply, the USSR, taken together with its Eastern neighbors, represents today the world's largest untapped market. With its vast natural resources, well-educated population, low wage rates and zeal for modernization, the region will be to US companies what Western Europe was after the Second World War. Failure to adopt policies that put US companies in a position to compete agressively with their West European and Japanese competitors will represent a significant economic loss to our nation. Equally important, failure to give perestroika the bold support that is its due could jeopardize its ultimate success.

In terms of a sound national policy to take advantage of these opportunities, I recommend that the Congress treat the President's Malta commitments as a de minimis starting point and that it go considerably beyond those commitments both in defining the basic questions and in crafting solutions. The upcoming debate on the bilateral trade treaty offers an opportunity to conduct a broad review of US trade policy towards the USSR with the objective of encouraging constructive, commercially sound US participation in the development of the Soviet economy and vice versa. Among the measures that should be implemented promptly are the following:

- Full implementation of the President's Malta commitments. Work is already underway on the trade and investment protection treaties and the Export Import Bank is reviewing options for participation in the USSR. Instead of a waiver of Jackson-Vanik, Congress should repeal it altogether, recognizing the reality of today's relationship with the USSR and the collapse of the "Eastern Bloc". In addition, Congress should encourage the Administration to establish a special office, headed by an individual of Ambassadorial rank to coordinate efforts to provide technical assistance to the Soviet and East European economies. Ad hoc, uncoordinated efforts will have only minimal impact.

- Overhaul of the Export Control Laws. The Export Administration Act is up for renewal in 1990. This creates a major opportunity for harmonizing that law with the new bilateral relationship. As presently structured, the export control regimen costs US businesses billions of dollars annually in lost opportunities. At the least, the law should be amended to dramatically reduce the range of goods controlled; to promptly abolish all unilateral controls; to treat exports to joint ventures in the same manner that exports to other end-users are treated; and to require consideration of the economic significance of each export transaction as a key factor in the decision of whether or not to license. In addition, the Department of Commerce should be given sole responsibility for processing license applications to avoid duplication of effort and processing time. Finally, we question whether the proposed differentiation of licensing policy among East European countries and the USSR is either politically acceptable or enforceable. Political and economic reform in this part of the world is outpacing our bureaucrats' abilities to rewrite, much less enforce, regulations.

- Liberalization of travel and residency requirements for businessmen. Both countries should be required to normalize the rules that govern the movements within their borders of businessmen from the other country. On the US side, the quotas limiting the number of Soviet businessmen who can reside in the US should be lifted and the State Department should be required to process Soviet business visas in a matter of days, as the Soviets do for American businessmen (despite the fact that the volume of travel is much greater from the US to the USSR). Better yet, businessmen should be permitted to travel with visas that are valid for up to a year and for repeated trips. The USSR, for its part, should take the KGB out of the travel business and permit foreign businessmen to travel throughout the USSR, with limited exceptions.

- Opening up of US Commercial Offices outside of Moscow. The Congress should appropriate funds to create new commercial offices in such population centers as Leningrad, Kiev and Tashkent. Special consideration should be given to the port city of Nakhodka in the Soviet Far East, which is targeted for major economic development and for a key role in relating the USSR to all the countries that border the Pacific Ocean.

- Undertake a thorough review of all US laws that discourage or prohibit trade with the USSR. For example, the Agency for International Development issued a regulation in the early 1960s that denies A.I.D. financing for commodities that contain any component from "other than free world countries."

Such a restriction impairs the marketability of the Soviet commodity in the US, and as a result, potentially hurts the opportunity of US importers of this product to export their products to the Soviet Union. Further, application of this regulation could have an adverse impact on a wide range of U.S. companies.1/ A number of other obscure but equally harmful anachronistic laws also deter US banks and US manufacturers from free participation in the Soviet market.

These policies constitute the minimal program required to assist U.S. businesses to participate more effectively in the Soviet market on an equal footing with their competitors. In addition, the Congress should consider steps to affirmatively assist the perestroika process and to ensure that the process of decentralization and democratization continues. These might include: the grant of GSP status to certain Soviet imports; the creation of incentives to encourage certain US industries, such as manufacturers of health care, food processing, and environmental protection products, to participate in the Soviet market; the extension of various US trade-development assistance programs (for both agricultural and manufactured goods) to the USSR; and/or other forms of US government assistance to small and medium sized businesses seeking to enter the markets in the region. Special consideration should be given to support US companies seeking to participate in infrastructure construction

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1/ For example, a number of U.S. producers of phosphate fertilizers that contain ammonia source ammonia directly from the Soviet Union or store U.S. ammonia or ammonia sourced from other countries with Soviet ammonia. A strict application of the A.I.D. regulation would preclude these American companies from bidding on A.I.D. contracts. It is important that the U.S. Government rescind such outmoded regulations, which deter and retard East-West trade.

projects in the USSR and in East Europe. In this regard, modernization of the telecommunications sector is a prime business opportunity and one that, by linking these countries to the rest of the world, will help to prevent any backsliding into autarky. Finally, forgiveness of the lend lease debt or the extension of aid to certain sectors, conditioned on a defined pace of demilitarization should be considered.

Whether or not the objective is the elimination of discriminatory treatment or active support for perestroika, in defining the new rules governing trade the US should seek wherever possible to encourage the Soviets to adopt laws and policies that reduce protectionism and open the economy, protect foreign investors, make the legal system both transparent and accessible, and that conform with other basic rules governing international trade. In short, the US government should become an advocate for US business in a manner that pressures the Soviets to conform their business conduct to international norms.2/ This will help both sides tremendously.

The policies discussed above are all fairly obvious, based on current developments in US-Soviet relations. In addition, Congress should begin a broad inquiry into the long-term directions in which US-Soviet trade might move. Among the questions to be addressed are the following:

- How will the USSR and the various countries of Eastern Europe relate to the EC in 1992 and beyond? What impact will this have on the US relationship to the EC and to Eastern Europe?

- What economic development role can or should NATO, the Warsaw Pact or the Conference on Security and Cooperation in Europe play in regard to Eastern Europe and the USSR?

- What will the US response be to Soviet and/or East European investment in the US? (Soviet enterprises earning hard currency are now encouraged to invest in Western markets. Soviets are also actively looking for joint venture opportunities in the US).

- What new roles might the two countries play in the Pacific region and what impact might that have on the economic balance of power in that region? (The Soviets are renaming Nakhoda Bay America Bay and US companies, like their Asian counterparts, are actively exploring investments in the region.)

2/ The current conduct of foreign trade by the USSR is characterized by lack of transparency, lack of consistency, and lack of a consistent, predictable legal framework.

- Is there room for collaboration by US and Soviet companies that are converting from military to peacetime production -- particularly in regard to the joint exploration of space or the development of new technology? (US investors are already finding that Soviet enterprises that formerly produced for the military make excellent partners in terms of employees, access to supplies, technical expertise, etc.)

- Can the US or the US and the USSR jointly benefit from the capabilities of agencies of the UN as they seek to build new trade relationships with each other and/or jointly in Third-World countries?

In short, instead of quibbling over whether or not to grant the Soviets MFN, almost a non-issue, Congress should seek to define a model to guide the Administration as it tries to transform the bilateral relationship from one that has been primarily hostile with little or no trade into one where the military role will be greatly reduced and trade and economic relations will be a primary component. Full participation by the US in the new market opportunities presented by Eastern Europe and the USSR is a far more promising option than is the adaptation of backward looking protectionist policies.

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Foreign Investment in the USSR

by Sarah C. Carey

The Soviet Union today faces a huge demand for capital to pay off its growing deficit, to modernize industry, and to satisfy consumer requirements. To meet this demand, Soviet policy makers are exploring a range of options that include the sale of bonds, the lease or privatization of a variety of state-owned properties, and dramatic cuts in defense spending. In addition to these potentially far-reaching measures, it is likely that a significant percentage of capital requirements will be met by foreign trade and investment. Soviet economist Nikolai Smelov estimates that over the next decade foreign trade and investment (along with cooperatives and small family businesses) will comprise thirty to forty percent of the Soviet economy.[1]

The USSR offers vast and varied natural resources, an educated population and comparatively low production costs. If it can assure adequate economic stability and a good return on investment, it should become a desirable market, particularly as investment vehicles expand. At present the only way that foreigners can invest in the Soviet Union is through joint ventures, or, on a smaller scale, as members of cooperatives. In the next few years a steady expansion of investment opportunities can be anticipated, with foreigners participating in long-term leases of land and other property, as stockholders of Soviet businesses, in special Western-organized investment funds designed to finance new businesses in the Soviet Union, and in Soviet bond offerings, currency auctions, and other financial markets. The rules governing such participation can only be conjectured at this point, but there is little debate that the scope and configuration of foreign investment in the USSR will continue to expand.

Emerging Investment Opportunities

Western investment was encouraged in Russia during the last three decades of the tsarist regime, as it was during certain periods immediately after the revolution. Stalin abruptly cancelled this policy in the early 1930s,[2] and the USSR remained a highly protected, autarkic economy until the late 1960s. During the 1970s some erosion of this protectionism occurred, with the inclusion of large scale "compensation" agreements with Western firms, particularly in the chemical industry. Under these arrangements, Westerners constructed large manufacturing complexes, receiving payment in the resulting product. The Western investor did not have an ownership interest in the factory, but did have a contractual claim to a defined percentage of its production.

In January 1987, as part of Gorbachev's overall plan for economic restructuring, the Soviets announced dramatic changes in the organization and conduct of foreign trade and investment. A series of policy pronouncements and Council of Ministers' decrees signalled a new Soviet commitment to making the ruble convertible and to becoming a significant player in international markets, including seeking membership in the GATT, the IMF, the World Bank, and other international trade and financial organizations. In addition, a gradual abolition of the Ministry of Foreign Trade's monopoly over export and import activity was announced, culminating in April 1989 in the granting of authority to all enterprises and production cooperatives to trade with foreigners directly. The banking system was reorganized, again with a proliferation of new players, a number of which have the right, with Vneshekonombank's permission, to engage in foreign trade. Most important, the Soviets reversed their long-standing ban on foreign investment by inviting foreign participation in joint ventures.[3]

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[1] Interview in *BLOC Magazine*, premier issue, 1989, p. 29.

[2] During the early stages of Soviet economic development, for example the period of 1889-1913, foreign capital (primarily from France, England and Belgium) accounted for roughly forty percent of industrial development and fifteen to twenty percent of total investment. During the NEP period (1921-1928), foreign concessions were granted and credits from the capitalist world were sought but foreign trade did not reach pre-revolutionary levels.

Under the new joint venture laws, as amended, a Western company may own ninety-nine percent (probably one hundred percent) of an enterprise (the joint venture) in the USSR, may designate the chairman of the joint venture or its general director, and may play a dominant role in management decisions. The joint venture may engage in virtually any legitimate business activity not reserved to the state. Joint ventures are in operation or being negotiated in virtually every industry (except the military), in localities previously closed to foreigners (such as Kamchatka, Vladivostok, and Magadan), with partners that previously operated exclusively in the military sector (for instance, the Ministry of Medium Machine Building), and in sectors previously controlled by state monopolies (Intourist, Minsviaz, etc.).

The joint ventures in the process of negotiation touch virtually every facet of the Soviet economy. Although cumulatively they are small in terms of total investment, their significance is considerable because of their competitive impact. For example, one has only to visit the Hotel Savoy, a Soviet-Finnish joint venture, to see that it sets a new standard for Moscow hotels. And it is no coincidence that Minpribor (the Ministry of Instrumentation) was abolished a year after two joint ventures were established for the distribution of process control systems, products that previously fell under Minpribor's jurisdiction.

The joint venture law is an experiment — a first, closely-observed step in a continuum that, in the next five years, will undoubtedly result in diversified foreign investment opportunities in the USSR. One new opportunity — the creation of free economic zones offering special concessions and incentives to encourage economic development — was announced two years ago.

In addition to the zones, which are largely motivated by a desire to increase foreign investment, many of the major reforms directed primarily at the domestic economy will also be open to foreign participation. One such reform currently being discussed by the Supreme Soviet is the right to execute long-term leases for the use of land, farms, factories, capital equipment, transport vehicles, and a host of other assets (leases of fifty years or longer have been proposed; some policy-makers are talking of ninety-nine years).[4] According to a current draft of this law, in certain circumstances the lessee may obtain title to the leased property upon expiration of the lease (assuming the fees paid cover the cost of the property).

The Supreme Soviet is also heatedly debating the issuance of bonds to finance the national debt and stocks to finance new economic development.[5] In December 1988 it authorized a system of currency auctions. These auctions are now open only to Soviet enterprises, but they allow hard currency to be traded for rubles at market rates defined by the auction participants. A trial auction was conducted in March 1989, followed by a full-scale auction in November 1989, with promises of regular auctions to come. The ruble traded for ten to a dollar at the first auction and fifteen to a dollar at the second.

Recently, the Supreme Soviet gave cooperatives the right to buy out failing state enterprises — and since a foreigner may be a cooperative member, he may end up owning a piece of an enterprise. Although enabling legislation has not yet been proposed, there is serious discussion on legalizing the dollar (thereby permitting the circulation of two currencies), issuing gold-backed bonds, and backing the ruble with gold reserves or other valuable resources, all as a fast track to convertibility.

Although the labels are different, Soviet policy makers are seriously considering the creation of a range of new financial instruments and the sale or "privatization" (primarily through the lease vehicle) of a range of state properties. The question of whether and at what levels foreigners will be permitted to participate in these markets remains open. Investment initiatives are also being launched from the West. At least one USSR venture fund has been announced[6]

Soviet borrowing and investment activities in the West can also be expected to expand. This activity will stimulate new relationships between Soviet and Western investors and money managers that will, in turn, result in a continuing expansion of investment opportunities in the USSR.

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[3] January 1987, Decree No. 49 of the USSR Council of Ministers, "On the Establishment in the Territory of the USSR and Operation of Joint Ventures with the Participation of Soviet Organizations and Firms from Capitalist and Developing Countries"; September 1987, Decree No. 1074 of the USSR Council of Ministers, "On Additional Measures to Improve Foreign Economic Activity in the New Conditions of Economic Management"; December 1988, Decree No. 1045, "On Further Development of the Foreign Economic Activity of State, Cooperative, and Other Public Enterprises, Amalgamations, and Organizations"; and March 1989, Decree No. 203 implementing Decree No. 1405.

[4] Finnish interests are already negotiating long-term leases in the northwest USSR, and Japanese interests are reportedly doing the same in the Far East.

[5] Soviet Minister of Finance Pavlov has stated that the government plans to introduce "enterprise shares" — cross shareholdings held by one enterprise in another that eventually could be traded on a stock exchange. The Soviets also plan to authorize the issuance of workers' shares in their own factories that initially could only be resold to the enterprise. (*Financial Times*, August 4, 1989, p. 1.)

[6] The Soviet American Venture Capital Firm has been established to finance start-up Western ventures in the USSR (*Journal of Commerce*, October 21, 1989, p. 4A). The creation of an Environmental Fund composed primarily of contributions from Soviet polluting industries and supplemented by Western contributors is also under discussion. This fund will invest in high growth Western stocks and will provide low cost loans to new Soviet joint ventures that produce environmental cleanup products.

Although until recently the USSR has been a minor participant in world money markets, operating largely through state organizations, the level of investment and the players are expanding. At the beginning of the year, the USSR's foreign debt stood at thirty-three billion rubles, including twenty-eight billion rubles in freely convertible currencies, or fifty-three billion dollars; these borrowings were concentrated largely in infrastructure development, with the balance accounted for in trade loans. Soviet economists say that the USSR will require an infusion of more than sixty billion dollars in foreign capital and investment over the next five years to help meet the short- and medium-term goals of *perestroika*, including a sharp increase in imports of consumer goods.

The Soviets, in addition to seeking Western capital, will accelerate investment in the West as a result of Decree 1074, "On Additional Measures for Improving Foreign Economic Activity Under New Management Conditions." This law encourages state enterprises to consolidate their funds for purposes of investing in Western financial markets. It also calls for new training and academic study programs to prepare personnel "for participation in foreign stock market ventures" and "investment activities abroad."[7]

The following pages examine the Soviet experience with joint ventures over the past few years, treating those ventures as a microcosm of foreign participation in the economy. Some emerging investment opportunities are also discussed.

Joint Ventures

The Soviet joint venture experiment, the first major effort to encourage foreign investment, is now almost three years old. The progress to date in terms of the number of businesses created and the total level of capital investment is not dramatic. However, the experiment in new forms of doing business and foreign ownership in the USSR is significant, paving the way for more extensive reforms.

As of October 1, 1989, almost 950 joint ventures had been created in the USSR with a total Western direct investment of around 1.49 billion dollars. Over ninety-five of these were with US firms. Most of the Western capital contributions came in the form of transfers of machinery and equipment, know-how, patents, etc., with the cash contribution constituting only twenty to thirty-three percent of the Western investment. By far the largest number of new enterprises focused on business or engineering services, and on the production of personal computers and computer programming. Considerably fewer were in manufacturing. By the end of 1989 it is expected that another 250 to 350 joint ventures will be registered. The 1989 experience suggests a gradual increase in the confidence of Western investors as well as the greater complexity of negotiating manufacturing ventures.

Joint ventures exist or are being negotiated in virtually every sector — hotels and tourism, entertainment, publishing, computers and software, telecommunications, environmental protection products, food processing, energy and natural resource extraction, health care and hospitals, transportation, mining, etc. Among the major joint venture projects recently concluded or currently under discussion are: The Combustion Engineering-Neste Corp. (Finland) petrochemical joint venture with the Ministry of Chemical and Oil Refining Industries in Tobolsk, Western Siberia; Occidental Petroleum's six billion dollar petrochemical project on the Caspian Sea, as well as its two polyvinyl chloride plants in the Soviet Ukraine valued at two hundred million dollars; the Japanese paper-pulp complex with an annual capacity of two hundred thousand tons in Sakhalin; and the consortium telecommunications project recently announced by US West (including British Telecommunications, Denmark's Denwa, Australia's OTC, Italy's Sovieta Finanziaria Telefonica PA and Denmark's Telecom) to construct a trans-USSR fiber optic cable that will be connected with international cable systems in both Europe and Asia. The American Trade Consortium (a group of US companies joining together to pool hard currency earnings and other resources) states that by 1990-1991 it will have at least twenty-five joint ventures officially registered that collectively are expected to generate five to ten billion dollars over the next fifteen years. These projects, and many others of lesser scale, demonstrate the diversity of Soviet joint ventures and their broad penetration of the economy.

The process of negotiating joint ventures and the operating rules that govern them are now clearly established. The joint venture's governing board is free to set the policy for virtually all aspects of its business operations, including import and export practices, production targets, pricing policy, distribution systems, and personnel policy. It is not subject to the control of various Soviet state organizations that regulate the domestic economy, such as Gosplan, Gosnab, Goskomtrud, and Goskomtsen.[8] Joint ventures have some independence in meeting their needs for insurance, banking, and accounting services, although in each of these areas certain basic Soviet requirements must be met. And once its core activity is approved, a joint venture is permitted to engage in a range of other activities, such as trading in unrelated products, or real-estate development, particularly if those activities are necessary to generate the hard currency required to meet obligations to its Western partner.

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[7] See also USSR Council of Ministers Decree No. 412, May 18, 1989, encouraging the creation of Soviet organizations abroad to, among other things, trade in foreign stock exchanges.

[8] The joint venture does, however, have to conform with regulatory requirements designed to protect the public, such as workers' safety, consumer protection, public health, environmental and other rules.

The major problems confronting joint ventures derive from the transitional, unstable nature of the Soviet economy and not from the joint venture regulations themselves. Problems are also caused by the avalanche of new Soviet laws already passed or in deliberation that impact all aspects of commercial activity. For example, since 1987, in addition to the overhaul of foreign trade described above, the role of industrial ministries and state regulatory bodies has been re-defined, resulting in a transition from an operational to a norm-setting or regulatory role (several ministries have been abolished). At the same time, state enterprises have been given greater independence and new responsibilities. New business forms have been created — cooperatives, joint stock companies, and individual proprietorships. The laws defining intellectual property rights, the banking system, taxation, and the rights of workers have also been rewritten. In addition, basic concepts of property and ownership are being re-defined, as are "intergovernmental relations" — the balance of power between the central government and the republic and local governments, with new tax and other powers devolving to the localities.

The key problem areas for Western joint venture partners created by this avalanche of change include the difficulty of getting paid in hard currency (due to the non-convertibility of the ruble), the inability to insure adequate suppliers and customers due to the vagaries of the Soviet distribution system, the inability to obtain adequate financial or performance guarantees, and the confusion caused by the decentralization of governmental and commercial decision making.

Getting Paid — The Convertibility Problem

A number of major corporations are deciding to enter the Soviet market for the long haul, positioning themselves for the day when the ruble will become convertible. The Soviets have declared this to be a key policy objective and Minister of Finance Pavlov has projected convertibility by the year 2005. In the interim, these companies are willing to accept their share of joint venture profits in rubles and to invest them in expansion of the joint venture or in other businesses in the USSR.

Other Western companies do not have a serious problem because their primary investment objective in the USSR is to secure access to raw or semi-processed products. This group includes companies whose primary focus is the development of natural resources, such as oil, copper, gold or timber. These companies are perfectly willing to take payment in the resource produced, in either raw or semi-processed form, and to resell it in hard currency markets. In a striking development, the Soviets are opening up virtually all of their natural resources to foreign participation. The challenge to the foreign company involved in natural resource development is twofold: to construct a fair arrangement that permits the Soviets adequate control over, and rewards for, their natural wealth, and to meet increasingly stringent local environmental requirements.

A number of Western companies are involved in projects that sell products or services to the international community for hard currency. This category includes the hotel and tourism industry, engineering or environmental consultants working on Western projects, and some aspects of the telecommunications industry.

The Western investor also overcomes the convertibility problem where the joint venture produces a percentage of its output for export to hard currency markets. Many joint ventures allocate part of their output to markets, agreed upon by the partners, that are not in competition with the already established markets of the Western partner. Others produce specific components or "contract" products for sale to the Western partner, which incorporates them into its global manufacturing or marketing operations (for example, valves for process control systems). Still other joint ventures, in addition to the finished products produced for the Soviet market, manufacture semi-processed materials that are marketed in the West, such as intermediate chemicals or wood chips for pulp.

The final mechanism for generating hard currency is countertrade or switch trading. The Soviet joint venture rules permit the Western joint venture partner to accept payment in products unrelated to the joint venture's production or to purchase such products with its ruble profits. These goods, which ordinarily would be available only for hard currency, can then be sold to trading companies that in turn distribute them through their regular channels. Trading houses, in growing numbers, are becoming expert in these transactions.

Together these approaches can support billions of dollars in trade. However, for every solution to the ruble dilemma that is developed by joint venture partners, at least as many joint ventures fail in the negotiation process because of the Western partner's inability to get paid in hard currency. To address this problem, at least one prominent Soviet economist has proposed that the Soviet government guarantee convertibility for joint ventures.[9]

Absent such guarantees, further problems for joint ventures may be created by the proposed establishment of a three-tier system of exchange rates, along with a significant devaluation of the ruble. The three-tier rate contemplates one rate for non-commercial transactions such as travel and certain services, introduced in November 1989, a second rate for transactions involving manufactured goods (to be introduced in January 1990) involving a fifty percent devaluation of the ruble from its current exchange rate, and a third rate applying to transactions involving energy and raw materials. This will be a devaluation to about R0.85=$1. A unified commercial exchange rate may be introduced in early 1991, further devaluing the ruble to R2.00-2.50=$1. Among other impacts, the devaluations will create a hardship for those joint ventures that manufacture products for the Soviet market and that rely on components imported for hard currency.[10]

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[9] This suggestion has been put forward by the Soviet economist Stanislav Menshikov, who has also proposed the joint ventures be granted a tax exemption for ten years (*New York Times*, September 22, 1989, p. D2.)

Distribution Problems

Untangling the Soviet distribution system — with its mixture of wholesale trade, contract trade and "state orders" administered by the industrial ministries — is a real challenge. Solutions to the inefficiencies and contradictions of the system are elusive. Initially, manufacturing joint ventures sought to ensure the delivery of supplies sourced from the local market, as well as the distribution of the joint venture's output via guarantees from the Soviet partner's parent ministry. With some notable exceptions, these guarantees proved difficult to obtain. Equally important, they may be impossible to enforce as the ministries' powers are reduced.

The most viable solutions to the problems of the Soviet distribution system can be found at the local level in the form of long-term supply commitments from Soviet manufacturers and output commitments from potential customers. Some joint ventures are seeking to include suppliers and/or major customers as partners on the Soviet side or even to create their own distribution systems. For the short term, Western investors can achieve the greatest security by "walking on both sides of the street" — betting on the past by seeking ministerial or higher level guarantees, while at the same time betting on the future by negotiating firm contracts at the local level.

The Elusive Guarantee

Besides guarantees of supplies and markets, Western businessmen and bankers are also seeking performance and financial guarantees. Westerners involved in some of the major resource development projects in the Soviet Far East, for example, have sought guarantees that have the full faith and credit of the Soviet state, their reasoning being that the state, in large part, will determine the success or failure of the project. Such a guarantee can only come from the Soviet Council of Ministers and will not be given readily.[11]

A number of bankers have sought more modest guarantees from the organizations whose purchases they are financing. For example, a Western bank financing the sale of ships to Sovkomflot, a new Soviet joint stock company with many of the attributes of a Western corporation and with jurisdictional ties to Minforflot (the Ministry of the Merchant Marine), raised the question of who could provide adequate guarantees. After extensive research, it was concluded that although Sovkomflot's charter, issued by the Council of Ministers in 1989, states that it owns its property, there is no generic statute defining the attributes of companies such as Sovkomflot. In the absence of such a statute, the Merchant Marine Code (passed by the Supreme Soviet and therefore of higher level than the Council of Ministers' approved charter) prevails. The Code states that all Soviet ships belong to the state. This means that until a new corporate law defining the attributes of joint stock companies such as Sovkomflot is passed, Sovkomflot cannot pledge its major assets. Similarly, its parent ministry cannot provide the sought-after guarantee because it has no resources other than the normal office and other equipment required for running a government agency. This leaves only Vneshekonombank, a party not directly involved in the transaction and one that has tremendous discretion to decide whether or not to participate.

The lesson to be derived from this example is that as the Soviet economy moves from a centrally-controlled, government-administered economy to a more decentralized, privately-controlled model, guarantees will be difficult to obtain and enforce. This will result in makeshift efforts to secure other forms of contractual commitments from Soviet parties involved in the transaction. Where the joint venture in question is one of political significance because it responds to a top priority of Soviet economic planners, it may be possible to secure special commitments from superior organizations. Soviet policy-makers recognize that problems caused by the failure to harmonize new experimental economic laws with traditional civil code provisions creates contradictions and uncertainties that discourage foreign investment. To overcome these problems, at least until the massive volume of economic laws currently being drafted is finalized, Soviet politicians appear willing to make extraordinary commitments that they will honor in order to avoid political or economic embarrassment.

Decentralization of Decision-Making

New Soviet laws are redefining the powers of regional and local governments and are also giving local enterprises new decision-making authority. In meetings with Soviet businesspeople from such diverse areas as Karelia (on the

[10] *PlanEcon Report*, Vol. V, No. 41, October 13, 1989.

[11] At least one project has received guarantees from a republic Council of Ministers, an avenue that offers promise for the future as the republics become increasingly involved in economic activities.

border of Finland), the Primorski Krai (on the Pacific Coast), and Tashkent (the capital of Uzbekistan in Central Asia), we have found that both local government officials and local businessmen are eager to exercise their new authority and are urging Western businessmen to deal directly with them rather than through the center. In certain industries such as agriculture, the central ministry (Gosagroprom) has been dissolved and the action is truly at the local level.

This creates a range of problems for joint ventures. For example, the joint venture decrees define two kinds of taxes — a tax on venture profits and a withholding tax on repatriated profits. At least for the first two years these were interpreted by Soviet authorities to be the only taxes applicable to joint ventures. Recently, a value added or turnover tax has been applied to those joint ventures that produce retail products and it is inevitable that as local and republic governments exercise their new taxing authority, whether as a direct tax on income or a tax on the use of natural resources, joint ventures will not be immune. In anticipation of this problem, some joint ventures have begun to make "voluntary" contributions to local governmental entities.

Initially, Western investors in joint ventures negotiated almost exclusively with the parent ministries for the industries in which they sought to invest, allowing those ministries to designate the actual business partners. Even when manufacturing was involved, the Western side paid little attention to local government authorities or to local political groups, such as environmental organizations, and did not focus on the characteristics or capabilities of its ministry-designated partner until late in the negotiating process.

Today the picture has changed radically. It is now impossible to negotiate or obtain approval for a manufacturing joint venture without the strong support of local authorities, including the approval of the local and/or regional environmental organization. Western businessmen are also realizing that they must take the initiative in selecting their business partners, weighing the competing strengths of potential partners. Finally, individual republics are beginning to enact their own laws, which in many areas impose requirements or establish standards that exceed the national norms. This development requires careful initial research regarding local regulations and incentives.

Foreign Economic Zones

The zone concept is one that promises to attract significant and diverse foreign investment. For over a year, Soviet policy-makers have been drafting concepts for free economic zones and have visited similar zones in the PRC and elsewhere. Enabling legislation can be expected in early 1990.[12] As presently conceived, a generic enabling law will be enacted, to be followed by individual decrees approving specific zones in regions where the local population has voted to develop one. To date, local initiatives have passed in both Vyborg and Nakhodka.

The Soviet zones will not be confined to coastal areas, but will extend to the interior. They will give as much focus to economic development and to the development of necessary imports for the regions where they are located, as to the generation of exports. Zones in different locations will have different development focuses (e.g., development of natural resources in the Far East, of tourism, electronics, and dairy farming in Novgorod, and of high-tech products near Leningrad).

The concessions and incentives that are available to companies participating in a zone will apply to distinct geographic areas designated as zones. They may also apply to individual projects, regardless of location, that meet zone criteria. A broad range of concessions and incentives will be made available, including significant tax and rent discounts, the creation of a special currency such as a gold-backed ruble transferable both internationally and among zones, preferential customs treatment, freedom to experiment in regard to management and employment practices, and relative financial independence. Foreign companies can establish fully owned subsidiaries in the zones. The central government will finance initial construction for zone infrastructure in locations of "national or republic significance." State orders, at least to some extent, will insure markets for zone output.

According to the latest concept paper, zones may be initiated by the central government, the regional government, or a group of foreign corporations. Each zone will have "the authority of a national ministry" in its economic relations with the central economic organs of the USSR. Internally, it will have the power to pass its own laws. The businesses participating in the zone are expected to participate in its governance, presumably through some sort of advisory committee structure.[13]

A number of key questions regarding the structure of the zones remain unanswered, such as the relationship of the zone to the rest of the Soviet economy or the level of state subsidy for infrastructure construction. Nonetheless, Western companies are already pursuing zone projects. Finnish interests are pursuing a zone near Vyborg and are negotiating the lease of land for that purpose, and Japanese interests are doing the same in the Primorski Krai.

At least one US group of companies is negotiating with regional authorities regarding the terms and conditions that will govern a zone in the Soviet Far East. These US companies have been accorded an extraordinary reception by local officials as they develop plans for converting the Nakhodka military airport to civilian uses, for launching a Nakhodka-Japan shuttle air service, for designing a modern telecommunications gateway to connect zone commercial activities with Asia, and for other infrastructure projects. At least symbolically, the US companies have been heartened by the proposed renaming of the Bay of Nakhodka to "America Bay."

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[12] The free trade zone is not a new concept. Odessa had such a zone in the last century, and it played a substantial role in that city's development.

[13] Concept paper, Spring 1989, USSR Commission on Foreign Economic Ties.

How to Acquire State Property

In recent months, the Supreme Soviet has had under discussion a draft law to permit the leasing of a broad range of assets, including the property of collective farms and state enterprises, individual buildings, equipment, means of transport, livestock, "and other material values." According to these discussions, the duration of a lease may be "from five to fifty years or even longer and is subject to renewal." In at least some instances, the lease is viewed as a "financing lease" where the lessee ends up owning the property upon the termination of the lease. Such leases can be passed on through inheritance practices and can be pledged as security on loans.

The wording of the law currently under discussion describes eligible lessees as "*sovkhozes*, *kolkhozes*, or other state cooperative or other social enterprises (organizations) including organizations of lessees, collectives of their subdivisions, or else a citizen or group of citizens."[14] This would appear to include joint ventures involving foreigners. As noted above, the Soviets are already allowing groups of foreigners to negotiate long term leases of land, at least in the context of free economic zones.

The law on leasing, because of the long-term nature and other attributes of the leasehold interest, opens up dramatic opportunities to Western agriculture interests, developers of office and commercial property, and others. As long as the holder of the lease controls the property, these investors do not care if formal title resides in the state.

Malta and Beyond

Foreign and particularly US investment in the Soviet Union today is minimal. The instability of the economy, the lack of adequate guarantees and the lack of certainty in the legal regulation of commercial activity, along with pre-Malta discriminatory US policy towards trade with the Soviets, are all deterrents to US investors. The Soviet economic system remains highly regulated, with the center still having significant power to determine the success of many economic opportunities that are labelled private. The investment opportunities available to foreigners also remain limited.

However, the trend lines toward new financial instruments, expanded avenues of investment, and a reduction of the role of the state in the economy are positive and accelerating. Further, the openness of Soviet policy-makers and businessmen to the advice of foreign economists, business executives, regulators, and others is producing extensive collaboration that will encourage a gradual but continuous increase in foreign investment. The shift in US policy articulated by President Bush after the Malta Summit should also be an impetus for increased trade and investment.

Given the right Soviet policies, foreign investment will continue to grow. Furthermore, if the ruble becomes convertible, if the Soviets issue a gold-backed ruble, or if Western joint venture partners are guaranteed the right to repatriate their profits — all of which are under discussion — the rate of investment will accelerate dramatically. It is difficult to predict at this stage who will be the major beneficiaries. Immediate neighbors such as the Japanese or the West Germans are logically the major investors in the USSR. But these patterns will depend, in large part, on the relationships that the Soviet Union carves out with the European Community, the ASEAN countries, and other trading blocs.

In any event, there is no question that a year from now foreign investment activity in the USSR will present a much different profile than it does today, based on the ingenuity of capital-hungry Soviets and of Western investors with extensive experience dealing in other regions of the world where currencies are blocked, inconvertible or constantly being devalued.

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Note: For reasons of readability, *The Harriman Institute Forum* now uses the transliteration system of the U.S. Board on Geographic Names.

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[14] "USSR Supreme Soviet Presidium Decree on the Lease System and Lease Relations in the USSR," *Pravda*, April 8, 1989 (FBIS).

Senator LEIBERMAN. Thanks, that was great.
Dr. Welfens.

STATEMENT OF DR. PAUL J.J. WELFENS, AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES, JOHNS HOPKINS UNIVERSITY, WASHINGTON, DC

Dr. WELFENS. In my written testimony I have briefly laid out the problems faced by the reform economies in Eastern Europe—especially the legacy of the command economy with these monopolistic structures. And if you are looking for natural allies in that business community, you will have to wait a long time unless these countries are successful in privatizing the companies, the state companies, and also launching new businesses.

Fortunately, the communist governments neglected very much the service economies so there is hardly any state enterprise, and that would be a good field to move in.

Well, then I briefly explained the role of cost-based pricing, that is that increased costs are translated to higher prices, which creates all kinds of irrationalities. And if American businesses are moving into an economy which goes through this transition phase, they, of course, will also have to deal with part of this strange phenomena. So I think the task which we are facing is really tremendous.

Then I explained the role of the switch to stagnation and I really would emphasize the role of technology. Western scholars emphasize that about a third of economic growth comes from technology. When you see, for instance, Poland imported massive Western technology in the 1970s and 1980s, and it brought just nothing in terms of increasing economic growth, then, of course, if the transition period is not handled properly in terms of technology matters, then you can invest a lot of money and you will see very poor results.

Then you have a particular problem in the socialist economies, which is the growth of the shadow economy over the past decade. There is a big unofficial economy which has created fortunes for some people and has worked to the disadvantage of other people, and this creates a particular problem for private enterprise because, especially in societies which emphasize the equality of income—it will be difficult to accept that there will be businesses which generate enormous profits, at least in the short term.

And then, of course, you have the results of that and these are tremendous political conflicts.

I would emphasize that in most CMEA countries the structural problems are very similar. The USSR is a separate case because the country is so big. Then when you take a look at the reform programs, I try to explain the role of sequencing, which seems to be tremendously important as regards the probability of success. I emphasize that if these governments take the wrong sequence of liberalizing, say, trade, privatization of companies, and so on, then we will probably embark upon a strategy which is not sustainable and what we need are sustainable strategies.

As regards the smaller CMEA countries, it is my view that a kind of shock therapy is probably unavoidable just because the pressure, the political pressure on the system is so great that we cannot afford to embark upon a long-term transition period which might be wise as regards theoretical merits. The practical measures which have to be taken must yield at least some visible success in the short run.

This does not mean that the long run is not important. If you can generate or if you have measures or if you have also investments which increase future expected income and thus change expectations, those of local business people and foreign business people, then, of course, this can be extremely helpful.

Then, as regards the inter-CMEA differences, that is, the differences within the COMECON, I would clearly say that Poland and is a key country of the reforms in Eastern Europe. I was not surprised to hear that Soviet officials are closely watching what is going on in Poland, and if Poland cannot be, or is not successful, I cannot think of any concept which could bring success, say, within this century.

Senator LIEBERMAN. Why is that? Describe that a little bit more. Because the new Polish Government is now experimenting——

Dr. WELFENS. Poland has taken the most decisive steps toward a market economy.

Senator LIEBERMAN. So in that sense, it is being looked at as a test?

Dr. WELFENS. This is one point. The other point is if we take a country like Hungary, it is just too small to be taken as an interesting model by the Soviet Union. And also if you compare the structure of industry and the trade relations then there are similarities between Poland the Soviet Union.

Also, now with the German unification issue, you get a whole new set of Polish/Soviet fields of mutual interest and that could be helpful, also.

Well, I then briefly suggest that one might consider encouraging a Baltic free trade area. We have already the EFTA, we have the EC and, of course, we have the GATT forum. So the idea would be promoting a new Baltic free trade area. It would build upon some historical experience and upon historical links between these countries, and it would also avoid or at least adjourn the problem of East European EC enlargement in the near future.

I mean it would already be nice, in my view, if Western Europe, the EC, can contribute to the stability in Eastern Europe just by completing its EC 1992 Program. So, if they are faced with too many problems from Eastern Europe, that would be extremely difficult.

If we had a Baltic free trade area we would get a kind of mutually overlapping membership between EFTA member countries—let us call that a BAFTA-member country and EC member countries and then the overarching framework that would promote free trade in the long term.

Well, what could the U.S. Government do in my view? I would emphasize that it does not make very much sense to think about export opportunities without considering imports. I mean, the whole United States/Japanese problems in trade clearly show this. And as it was emphasized already here, and I quite agree, there is a tremendous potential for increasing exports in Eastern Europe to the world market, but they would really desperately need advice, any advice they can get.

I mean, there are problems they run into and they do not take opportunities just because they have no experience. They are used to working with all types of bureaucratic support, and I also said that it would take at least 5 years or more to see some success. Well, then, of course, credits—or to increase credits to Eastern Europe, to reform-minded economies, would be quite helpful.

Then, encouraging regional cooperation as I said in the case of BAFTA, and then one important role not mentioned here so far is the role of the international agency. Take for instance, the International Finance Corporation, which is an agency of the World Bank, where the United States is quite an important member country, of course. It is just not enough what they are doing.

It is more or less, you could say, ridiculous if you hear that they have investments so far in two projects, some $40 million. It is nothing. If you hear that they have one person, for instance, based in Warsaw, one would hope that the United States could support their activities much more strongly.

And I think the United States is in a good position to help Eastern Europe, especially if you take into account the role of Poland. You have so many corporate citizens in this country and they could help to transplant part of the successful business tradition of this country.

And then, of course, the role of infrastructure was mentioned, and this brings specific problems because here in the United States you have very often private business involved in infrastructure projects and in Europe, regardless of whether West or Eastern Europe, you have state companies.

So the West European firms are at a kind of natural advantage because they take the route via their government. And then finally as an economist, I would say massive support for academic institutions dealing with the theoretical and practical analysis of the shift to a market-oriented system would be helpful.

I think that the Soviet Union is about 10 years behind Poland as regard to problems and as regard to process. So if we can make the Polish economy work, then that would be quite helpful for the Soviet Union in the long run.

[The prepared statement of Dr. Welfens follows:]

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Economic Reforms in Eastern Europe: Problems, Options and Opportunities

prepared for testimony before United States Senate, Small Business Committee,
Washington, March 23, 1990

1. The Legacy of the Socialist Command Economy
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    1.2. "Cost-based" Prices
    1.3. Stagnation
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2. Reform Programs
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4. Summary and Conclusions

1. The Legacy of the Socialist Command Economy

Based on a strategy of economic growth which relied on an increasing participation rate of the female population, massive exploitation of natural resources, the use of mass production and the promotion of heavy industries, the Eastern European countries increased output and productivity in the 1950s and 1960s. Then they also embarked upon a more specializing intra-CMEA-division of labor: In the Council of Mutual Economic Assistance, the smaller countries supplied mainly manufacturing goods to the USSR in exchange for the supply of energy and raw materials.

1.1. Monopolistic Structures

Opening-up the economies within the CMEA group brought no additional competition in Eastern Europe, but reinforced under the heading of international socialist specialization the fragile system-specific network of monopolistic firms which constitute the socialist official economy. As access to Western imports was tightly restricted, each firm faced high delivery risks with respect to the existing small range of specialized suppliers; even if input quantities were supplied in accordance with plans, there was the risk of quality problems whose occurance shows a considerable variance. Consequently, all kinds of strategic behavior of socialist firms were observed. The firms used their information advantage vis-à-vis the planning authorities to obtain generous input allocations that allowed them to cope with delivery risk and helped them to easily fulfill the quantitative targets of the state plans (problem of tautness of plans). Naturally, socialist managers were eager to overfulfill the plan, so that wage premia could be paid and career promotion be expected. If wage increases exceeded productivity gains, the rise in unit costs translated into higher prices, or, more often, into higher required subsidies that would cover the difference between costs incurred and prices obtained.

The socialist bias to supply the bulk of goods for basic needs at low or artificially lowered prices created (i) a sustaining excess demand in the goods markets, (ii) insufficient incentives to increase output, and (iii) continuing needs to allocate subsidies to firms producing mass consumer goods. Implicit excise taxes on certain goods were used by state planners who wanted to generate enough corresponding extra profits to cover the rising amount of subsidies for non-profitable firms. However, this mechanism for balancing the state budget did not work in the late 1970s and the 1980s, when increasing world market prices called for adjustments in the assortment of products produced, in the energy-intensity of technologies employed and in the location of industries. The USSR passed these oil price hikes with a lag to its major CMEA trading partners and enjoyed some windfall profits from the OPEC price surges; however, rising aspirations of the Soviet people could not be reduced, when world market prices for primary products and energy started to fall after 1981. The tremendous international relative price changes that occured in the world markets in the 1970s and 1980s hardly lead to major structural changes in the inward-oriented CMEA countries, where intra-bloc trade relied much on bilateralism and a myriad of exchange rates applied to different product groups. In the 1970s and 1980s the CMEA countries were facing increasing competition from the flexibly reacting Newly Industrializing Countries (NICs) which relied on an outward-oriented development strategy, relative world market prices, a strategy of nurturing firms and markets, an efficiency-promoting trajectory of progressively reduced protectionism and a successful adoption-cum-dissipation of modern technologies.

1.2. "Cost-based" Prices

In market economies higher energy prices were perceived as an incentive for resource/energy-saving technological progress, the closure of obsolete firms and the shift of many firms, towards novel products and new industry locations. These reactions were quite uncommon in socialist countries, where bankruptcy and explicit unemployment would not be accepted and where the demarcations of industries were defended by powerful branch ministries and well-organized monopolistic firms with their traditional reluctance to introduce technical progress. Increasing subsidies ultimately lead to higher government deficits and, if financed by resorting to the printing press, to repressed or open inflation. In the "cost-based" price system lies a core irrationality of the traditional socialist economy model. This is easily understood by looking at the counter-example of a market economy. The equation market price = marginal costs holds both in socialist and in market economies. However, in market economies the equation is read not from right to left, but from left to right: The market price (being the result of the ratio of aggregate supply to aggregate demand - of scarcity - in a given market) informs any potential supplier whether it is worthwhile to stay in or enter a market. As long as marginal costs faced by the firm are lower than the market price, expected profits encourage production: At the level of the individual firm, higher costs do not entail higher market prices, whereas the socialist firms used cost increases to obtain higher state-administered prices (more or less automatically, if the standard formulas for price calculations were employed).[1]

In the socialist countries the cost-based price determination, reinforced by the monopolistic industry structure, prevented efficient production and favored the excessive use of all input materials which ultimately resulted in a permanent excess demand for most input factors. This, in turn, gave the bureaucratic apparatus additional discretionary power: with state-administered prices and government-determined factor allocation, the mismatch between supply and demand on the input side worked to increase bureaucratic power. Some authority had to decide which priorities were to be set and hence which industries or groups should receive the desired inputs or goods and services. This mechanism may have created a tendency to generalize and sustain input shortages as a systemic pitfall that was permanently welcome by the bureaucracy with its myriad of rival branch ministries.

1.3. Stagnation

After 1976 economic stagnation and the negative repercussion effects of the intensive-growth-strategy became increasingly apparent in Eastern Europe, where Hungary and Poland had embarked upon a modernization strategy financed by western capital inflows. With high inflation rates in OECD countries, the associated low real interest rates greatly encouraged foreign indebtedness. This tendency was reinforced by political pressure or "encouragement" to extend loans to Eastern Europe.

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[1] An increase of costs at the level of the individual firm would thus induce in a market economy, that attempts to boost productivity and hence reduce unit costs are made or that new fields of profitable activities are sought.

With human and material production factor reserves increasingly exhausted, the switch to a more science-based expansion strategy became necessary - a challenge that was not met in Eastern Europe at all with the exception of a few technically successful ventures with insignificant economic pay-off, e.g. in the military industry. In addition there was no significant growth of the service industry, which had traditionally been discriminated in socialist countries; however, without a growing service industry that supplies customer-taylored services both to business and the household sector, there is no modern manufacturing sector and thus no prospering economy.

In industrialized market economies economic growth is roughly attributed equally to labor, capital and technological progress. With increasing factor inputs an industrial country might have a sustainable economic growth of 3 percent p.a. which implies a ninefold increase of real output in one generation (75 years), whereas a country with no growth of labor and know-how might grow at only 1 percent (doubling output in 75 years) or even stagnate. The traditional command economy which relies upon a monopolistic network of state-owned firms and priority allocation of government funds for high investment might generate economic growth as long as economies of scale from standard technologies or dynamic learning effects can be mobilized and as long as political legitimacy and hence working morale in the state-owned socialist production system is preserved. However, in the late 1970s and in the 1980s the changing direction of international technological progress confronted the socialist economies with three major challenges that were basically not met for systemic reasons:[2]

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[2] See WELFENS, P.J.J.(1987), Growth, Innovation Dynamics and Welfare: A Comparative Economic Systems Approach, paper presented at the second European Economic Association meeting, Kopenhagen, August 22-24, 1987; WELFENS, P.J.J. (1988), Innovationstheorie, -politik und -dynamik im Systemvergleich, in: Welfens, P.J.J.; Balcerowicz, L., eds., Innovationsdynamik im Systemvergleich, Heidelberg (Physica) 1988, 1-24.

- Resource-saving miniaturization (dubbed here "bonsai products", paying due attention to Japanese achievements) required sophisticated quality control and the full mobilization of individual know-how and skills at the shopfloor level: neither the intra-firm communication structures in the socialist sector and its incentive system nor the detail-neglecting command approach in R&D as well as in investment were up to this challenge.
- Flexible production techniques were not available which would have allowed the East European countries to meet the increasing demand for product variety that is typical for the stage after basic needs have been satisfied and which is a cornerstone for success in world markets; moreover the demand for services was not met by the slowly reacting planning system, where vested interests of heavy industry favored high investment in traditional industries. About 30 percent of national output was typically devoted to investment, but the CMEA countries never reached economic growth similar to Japan, where investment-output ratios hovered around the 30 percent margin in the 1960s and 1970s, too. Low interest rates and the "soft budget constraint" (KORNAI[3]) - meaning easy access to subsidies - encouraged permanent overinvestment, very often in inefficient projects.
- Ambitious to meet Western technological and economic advances, the political claim of communist party monopoly implied tremendous opportunity costs, as modern flexible communication, information and production technologies could not be applied on a wide base. With multi-use copy machines, modems, fax-machines and printers being considered as a threat to political control, millions of people were denied valuable experience with advanced technologies and know-how, where COCOM-restrictions added problems on the hardware-side. Software as well as hardware that could have been used to build more decentralized flexible production structures were hardly used, and - apart from the shadow economy - political control over the population with modern technologies was the only growth field left.

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[3] KORNAI, J. (1980), Economics of Shortage, 2 Vols., Amsterdam (North-Holland) 1980.

1.4. Growth of the Shadow Economy

Growing consumer dissatisfaction was the consequence of a system that offered neither the amount, nor the variety, nor the quality of goods and services desired. Shortages in the official system and overall production reserves thus generated a rapidly growing shadow economy, whose supply draws on overmanning and reserves of factor inputs in the socialist system as well as on leisure. Contrary to certain groups of the population which had privileged access to goods at low state-administered prices, many people had to buy goods and services in the price-flexible shadow economy with its high market-clearing prices; the result was a new economic inequality among people with their very different assets and skills to be used in the shadow economy.[4] The shadow economy absorbed part of the excess money supply that was created as a consequence of the government budget deficits covered by printing money at a pace exceeding output growth. The illegal nature of most shadow-economic activities - necessary and useful as they were themselves - nurtered a growing system of bribery and profit-sharing schemes that undermined the material incentive system applied in the official economy.[5]

Furthermore, as government in all CMEA countries set up "foreign exchange shops", where goods in short supply could be bought by foreign and domestic residents, the population's demand for Western foreign currency gradually increased, especially after inflationary expectations spread in the 1980s. With a state-administered fixed exchange rate system at overvalued parities, growing shortages in the official economy, and the increasing openness of the CMEA countries for Western businessmen and tourists in the 1970s, the expansion of black currency markets was fueled both from the demand and from the supply side. Systemic and external forces favored the shadow economy, namely in a way that severely disturbed the already weak efficiency of the official economy; in contrast to the low price level of the capitalist shadow economy in OECD countries, prices in the socialist shadow economy are higher than in the unofficial economy with its subsidized prices and preferential supply of goods at state-administered prices: With 26 consumers A-Z expressing their demand for a certain good in the inofficial economy, the individuals A-H with the highest priorities as expressed by the individual willingness to pay will be served (in the official economy, patience when standing in line, good connections or party membership are the "priority criteria", favoring, say, persons I-T).[6]

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[4] See WELFENS, M. (1988), Das Phänomen der Schattenwirtschaft im Sozialismus, Osteuropa Wirtschaft, 33 (1988), 1-15.

[5] See WELFENS, M. (1989(, Bedingungen der Entstehung und Entwicklung der inoffiziellen Erwerbswirtschaft, in: CASSEL, D.; et al., eds., Inflation und Schattenwirtschaft im Sozialismus, Hamburg (S+W Steuer- und Wirtschaftsverlag) 1989, 375-404.

In the 1980s, the stock of foreign currency (evaluated at black market exchange rates) in Poland was almost as high as the stock of domestic money.[7] The Deutsche mark and the U.S. dollar were the preferred currencies in the long-observed process of currency substitution in Eastern Europe which implies reduced seigniorage gains for domestic central banks and ultimately a resource transfer to Germany and the U.S., respectively. The real devaluation of CMEA currencies in the 1980s increased the incentive to work for (foreign) cash in the shadow economy, to work abroad (mostly illegally in some EC countries) and to sell assets, goods and services to businessmen and tourists from abroad. Increasing absenteeism at the official workplace and the declining working morale reduced economic growth in the official economy, aggravated shortages and distribution conflicts in the official economic system, and furthermore eroded the political legitimacy of the socialist system.[8]

Parallel to the reduction of economic growth of the official net material product, the socialist shadow economy has expanded. Increasing shortages in the official economic systems, the gap between the structure of output as provided by the socialist system and the preferences of people, and - in some countries (CMEA: Hungary, Poland; also Yugoslavia) - double digit inflation have stimulated activities in the shadow economy. Goods are produced or privately imported, and durable consumer goods are exchanged as well as assets. Hence, part of shadow economic activities is value-adding and affects the allocation of factors in the overall system; other activities reflect mostly redistribution effects, where there is a clear tendency to generate considerable income inequalities that are difficult to accept for a society where equality of income and wealth has been emphasized officially.

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[6] See WELFENS, P.J.J., Allocation, Pricing and the Socialist Equilibrium Economy, paper presented at the V Conference of the Associazione Italiana per Lo Studio dei Sistemi Comparati, Pavia, Sept. 14-16, 1988.

[7] See ROTH, K.; WELFENS, P.J.J., Internationale Determinanten des Geldangebots, in: CASSEL, D.; et al., eds., Inflation und Schattenwirtschaft im Sozialismus, Hamburg (S+W Steuer- und Wirtschaftsverlag) 1989, 151-168.

[8] See CASSEL, D.; et al., eds.(1989), Inflation und Schattenwirtschaft im Sozialismus, Hamburg (S+W Verlag) 1989.

The shadow economy is by no means a quantité négligable. KORNAI argued that value-added in the unofficial economy amounts to roughly 20 percent of Hungary's GDP.[9] WISNIEWSKI's empirical investigation for Poland shows an acceleration of the shadow economy's share, too: from 3.8 percent in 1970 to 13.2 percent in 1982.[10] This problem is less evident for the USSR, Romania, the GDR and the CSSR, but there is some casual evidence that the second economy is growing in these countries, as well.[11] So far, analysis of the second economies in both socialist systems and in market economies has shown that the shadow economy contributes to the structural flexibility of the overall system and, to the extent that it transitorily reduces the political pressure for reforms, it has a considerable social mollifier function; the labor market is viewed to play a core role for shadow economic growth.[12] In the transition phase to a market economy the shadow economy - this time of the capitalist type - might become again a welcomed kind of social shock absorber.

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[9] KORNAI, J. (1986), The Hungarian Reform Process, Journal of Economic Literature, 24 (1986), 1687-1737; see also BREZINSKY, H.; ROS, C. (1985), The Development of the Second Economy in Hungary, Korean Journal of East-West European Studies, 1 (1985), 95-127.

[10] WISNIEWSKI, M. (1985), Zrodla i rozmiary drugiego obiegu gospodarczego w Polsce, Ekonomista, 1985, No. 6, 913-936. On Poland's shadow economy see also LANDAU, Z. (1987), Selected Problems of the Unofficial Economy in Poland, in: ALLESSANDRINI, S.; DALLAGO, B., eds., The Unofficial Economy, Aldershot (Gower) 1987. An interesting case study in the system of Poland's parallel markets is CHAREMZA, W.; GRONICKI, M., QUANDT, R.E. (1988), Modelling Parallel Markets in Centrally Planned Economies: The Case of the Automobile Market in Poland, European Economic Review, 22 (1988), 861-884. For a theoretical equilibrium model of the second economy see The "Second Economy" and Resource Allocation under Central Planning, Journal of Comparative Economics, 8 (1984), 1-24.

[11] See e.g. BREZINSKI, H.; PETRESCU, P. (1986), The Second Economy in Romania - Dynamic Sector, Discussion Paper, FB 5, Universität Paderborn, 1986. ASLUND, A. (1983), Private Enterprise in Soviet-Type Economies: A Comparison between Poland and the GDR, Osteuropa-Wirtschaft, 28 (1983), 176-193.

[12] CASSEL, D. (1986), Funktionen der Schattenwirtschaft im Koordinationsmechanismus von Markt- und Planwirtschaften, Ordo, 37 (1986), 73-104; CASSEL, D.; CICHY, E.U. (1986), Explaining the Growing Shadow Economy in East and West: A Comparative Systems Approach, Comparative Economic Studies/ACES Bulletin, 28 (1986), 415-428.

1.5. Political Conflicts

In the early 1980s a dramatic deceleration of labor productivity growth was recorded in Eastern Europe.[13] Furthermore, declining terms of trade - reflecting reduced international competitiveness - contributed to the slowdown of economic growth, whereas many East Asian NICs have overtaken the CMEA countries in terms of per capita income in the past two decades.[14] Factors such as the rapid growth of the shadow economy, the weakening of the official incentive system, the external adjustment pressure, the visible politico-economic progress in Western Europe, the lack of internal consensus on how to achieve economic improvements and how to share the burden of adjustment all contributed to a politico-economic crisis.

Hence, politico-economic reforms had to be undertaken in several CMEA countries, most notably in Hungary, Poland, the CSSR and the USSR. Mikhail Gorbatchev marked with glasnost and perestroika a new era of public discussion about constitutional and economic reforms. In August 1989 under Prime Minister Mazowiecki and Minister of Finance Leszek Balcerowicz Poland embarked upon a market-oriented drastic reform program. In late 1989, Hungary's decision to open the border to Austria for citizens from the German Democratic Republic made visible the huge potential for "voting with one's feet" in the divided Germany; with the Berlin wall coming down, the peaceful revolution in East Germany (and later in the CSSR), and the "two-plus four arrangement" for talks on German unification, the situation in Europe has changed dramatically.

2. Reform Programs

All CMEA countries have launched politico-economic reform programs. In some countries this is not the first time that serious attempts are made.

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[13] The case of the USSR has been surveyd by OFER, B. (1987), Soviet Economic Growth: 1928-1985, Journal of Economic Literature, 25 (1987), 1767-1850. See for the CMEA countries as a group BRADA, J. C. (1985), The Slowdown in Soviet and East-European Economic Growth, Osteuropa Wirtschaft, 30 (1982), 116-128. For further empirical evidence see: SLAMA, J. (1988), Verwendung technisch-ökonomischer Kennziffern zur Analyse des Wirtschaftswachstums und des technischen Fortschritts sozialistischer Länder, in: WELFENS, P.J.J; BALCEROWICZ, L., eds., Innovationsdynamik im Systemvergleich, Heidelberg (Physica) 1988, 300-321.

[14] See WELFENS, P.J.J. (1987.1), Growth, Innovation and International Competitiveness, Intereconomics, 22 (1987), 168-174. See also WELFENS, P.J.J., Internationalisation of the Economy and of Economic Policies, Heidelberg (Springer) 1990/forthcoming.

However, in the past most reforms failed - for various reasons. At the beginning of the 1990s, some external factors in Europe might be helpful; others could be disturbing. Internal adjustment programs in major West European countries and the EC 1992 program aimed at the creation of a single EC market have already created sufficient growth momentum to reduce unemployment rates in Western Europe considerably, although the EC average of 8 percent clearly is still above figures compatible with full-employment. However, with positive expectations in the business community, the political pressures for protectionism in the EC are dwindling, and political stability in EC member countries might be expected for quite some time. A potentially destabilizing factor is the German unification process, although - if handled properly - it could generate positive momentum for the reform process in Eastern Europe; if German unification is not handled properly in the international political arena, there is a serious risk that the achieved degree of political consensus and cooperation in the EC may give way to old-style rivalries among major European countries. In this case the EC could not act as a stabilizing force in promoting successfull economic reforms in Eastern Europe.

2.1. Strategic Problems: Sequencing, Internal Consensus, Shock Therapy vs. Gradualism

The general decisions to be made by all reform-minded CMEA countries are the speed at which the marketization process can be introduced, and the sequence and combination of internal and external measures to be used in creating an efficient, socially acceptable market economy under democratic political government. Should capital imports, mainly foreign direct investment, be allowed first - along with a liberalization of trade - and only then privatization programs be enacted? Foreign direct investment by US or EC companies/subsidiaries in Eastern Europe typically helps to raise labor productivity and might boost exports of goods in the medium term, while the short-term impact is probably a deterioration of the trade balance - accompanied by an export-stimulating devaluation - due to growing imports of capital goods and intermediate products from the parent company, subsidiaries in third countries or other foreign suppliers.

Existing state monopolies are then confronted with foreign newcomers whose extreme competitive pressure makes restructuring very difficult. This presence of foreign firms could be used as an argument to preserve big state enterprises because of alleged economies of scale, thus foregoing at the same time the more valuable long-term benefits of intensified domestic competition. The monopolistic legacy of big state firms means that established well-organized interest groups from existing firms will exert extreme pressure on the political system not to dismantle big state firms. However, with the network of monopolistic firms more or less surviving, increasing domestic or foreign competition in the industries supplying intermediate goods will translate into higher profits of monopolistic firms at the end of the production line. This type of profit augmentation which actually reflects static rents or market power can easily be confused with an improving economic efficiency. If these big firms are then privatized, the resulting private industry structure is obviously not in line with economic efficiency criteria.

The alternative would be to realize a privatization program in connection with a dismantling of monopolistic firms. This seems to be the most urgent task in the sclerotic socialist economies. With a more competitive private business system, a higher degree of structural flexibility can be expected (there are important side-constraint problems, e.g. those stemming from regional labor immobility that grows out of a wide-spread shortage of housing). Greater sectoral and regional flexibility which allows the restructuring of the industrial landscape in accordance with changing efficiency requirements is needed as a prerequisite for the next stage of reform: namely, trade liberalization and gradual relaxation of capital import/export controls. A structurally more flexible economy can be expected to react more resiliently and strongly to changing exchange rates and international relative prices than a system consisting mainly of big business; this holds especially true, the more wide-spread the historically grown inflexibility of attitudes of a considerable share of workers and managers is. Moreover, a greater variety of firm sizes offers more prospects to set up the required broad range of international cooperative joint ventures and new forms of international investment. However, it is true that the dismantling of monopolies is extremely difficult in political terms. External pressure or support from international organizations might be helpful at times for the political system.

Internal Political Consensus

Any serious reform would face difficult transition phases in which the costs of reforms are already visible, while the fruits seem still uncertain. Moreover, the move to a market economy will certainly benefit entrepreneurial personalities and create fortunes which might fuel envy and social unrest. An income tax system that favors reinvestment and thus postpones high consumption of the early birds in the markets until the imitation reactions of many individuals spread wealth and incomes more evenly would be advisable.

The capability to build political consensus is extremely important, and this implies a prime role for constitutional reforms. Transition to pluralistic democracy means for most countries a transition phase with potential instability, because a multi-party system with many small parties and the lack of stable coalition patterns is the natural point of departure. This is true at least under proportional voting rules.

Shock Therapy vs. Gradualism

Even if there is a broad majority in favor of a transition to a market economy, the speed of adjustment must be determined. The unavoidable transition period coupled with uncertainty and stress upon consensus generating political mechanisms suggests that one should opt for a hard and short reform trajectory rather than a prolonged period of ambiguous reform policies in which every setback could endanger the whole reform project. With established anti-reform (old boys) networks, the historically accumulated legacy of weak credibility and reputation of governments, and the overall amount of problems faced, a radical program is obviously more adequate than gradualist concepts. In countries with (fragile) coalition governments a decisive (radical) move towards a market economy might, however, be impossible.

All long run private and government planning requires a stable, but adjustable framework of action. A stable monetary and financial framework is of particular importance, if benefits of a market economy are to be realized. Its efficiency is based upon the interaction of competitive forces and relative price incentives as well as creative long-term entrepreneurial activities. It is well known that high inflation rates distort the relative price signals severely and tend to favor shorter maturities in bond markets. This in turn means that investment projects which require long-term financing and which offer high yields in terms of productivity growth cannot be realized. Therefore, institutional reforms in the field of monetary control (relatively autonomous central bank) and prudential supervision as well as the nurtering of functional capital markets are of extreme importance. Only then can stable exchange rates and moderate shifts in the equilibrium exchange rates be expected, which in turn means that currency convertibility is closely connected with successful reforms of the financial and monetary system in socialist economies. High ratios of money to income which are typical for socialist economies with their frequent rationing of consumers and firms imply that there is a certain monetary overhang as compared with an economy where quantity rationing plays no role.

Hence moving to a market economy - i.e. getting rid of quantity rationing - means an inflationary boost. This is, however, only a transitory phenomenon which corresponds to a once-and-for-all adjustment of the price level. Naturally, for the ordinary citizen a once-and-for all-price level adjustment cannot be discerned at first from permanent inflation pressures. Here lies indeed a major problem, as trade unions might call for a full compensation in salary increases which would actually set in motion a wage-price-wage spiral if monetary policy is accomodating; if monetary policy is not accomodating, increased unemployment would result. Finally, there is another once-and-for-all adjustment in the price level of the official economy. As was argued above, the socialist system of distributing goods emphasized low state-administered prices that were supposed to allow everyone to purchase these goods (but in reality with lower prices each individual demands a higher amount of that good, and an overall excess demand results from fixing prices below market-clearing levels). The effective allocation of goods that results in this rationing context does not guarantee that people with the highest willingness to pay receive that good in the official economy at all. With the switch to a market economy, the principle of "serving the demand from above" (people with highest willingness to pay will obtain the desired goods) will entail higher average prices in all markets. This would per se increase the aggregate price level, unless the incentive and production effects associated with economic reforms do not lead to an offsetting increase in the supply of goods. A once-and-for-all increase of the price level could also result from the removal of state price subsidies, although a competition-augmenting supply-side policy might be able to dampen this effect by reducing static economic rents and promoting dynamic efficiency (a higher innovation rate).

The effective price level might be overstated to the extent that a capitalist shadow economy is evolving: avoiding the burden of taxation and costly regulations imposed upon transactions in the official markets is a trait of the capitalist shadow economy, and consequently the suppliers can offer goods at prices below the market price in the official system. Many individuals with low incomes would certainly shift part of their demand to a gradually emerging capitalist shadow economy, in which the unemployed could find some opportunities to increase their incomes beyond the level of unemployment compensation. Incomes from the shadow economy accruing from illegal work during official working hours increase in the socialist economy the effective wages associated with a particular workingplace. With reinforced work discipline, i.e. the loss of shadow economic incomes, many workers would certainly expect wages at least double as high as current official wages. This should be kept in mind with respect to perceived opportunities for foreign direct investment whose profitability is based upon low expected wage rates.

A general challenge for all reform-oriented CMEA countries lies in the mobilization of entrepreneurial spirit, the nurturing of market entrants and innovators by venture capital agencies, and the reduction of existing barriers to entry. The International Finance Corporation is already helping by providing financial and managerial assistance to some new business projects in East European countries. The EC has also offered funds for the promotion of firms. Managerial skills also have to be developed, and joint ventures with Western partners might help to achieve the desired learning-by-doing in a stimulating organizational environment.

A thorough modernization of the whole communication system is urgently needed because otherwise both internal and external business contacts cannot be developed, and the required information processing and flexibility with respect to changing market conditions would be impossible. Privatization of formerly state-owned monopolistic telecom and mail services would be a desirable step to establish a leading position in the strategic field of communication services. Gradual customs reforms should certainly abolish all duties on the import of telecom and office equipment right away. Otherwise government would create unnecessary impediments to stimulate the efficient organization of flexible modern production.

Regarding regulations, it would be preferable to have bad, but clear rules instead of an ever-changing series of regulations. The latter was the case with Polish joint venture laws (latest reform of the reform: December 1989). The average paid-up capital in Polish joint ventures was slightly below $ 1 mill. in 1989. Even if the number of joint ventures can be expected to reach nearly 1000 in Poland by the end of 1990, the small size of these firms shows that joint ventures can play only a limited role in promoting economic development. It is well known that considerable and fast transfer of advanced know-how and technologies is obtained by the host country only, if foreign direct investment laws allow for majority ownership by foreigners. With short innovation cycles in international markets, joint ventures are all the more limited with respect to the task of up-to-date modernization. However, joint ventures can certainly contribute to competitive spirit in a sclerotic business environment.

2.2. Intra-CMEA Differences

If practical experience could be accumulated rapidly in several CMEA countries, this might then encourage late-comers in reforms to accelerate the pace of adjustment and the scope of marketization. If the idea of sequencing is applied to the whole string of CMEA countries, the conclusion to be drawn is obviously that it would pay off not to encourage simultaneous reform projects in several East European countries. There is no need for reform synchronization, unless the smaller CMEA countries strive for closer (adjusted) trade links among each other. Some synchronization is brought about anyway by the envisaged orientation at world market prices. One cannot open up an economy in the expectation of reaping benefits from the world market without accepting international relative prices. This implies that state-administered prices must be abolished, possibly except for the case of some non-tradable goods and services in the short run. However, in the long run a market-consistent system of income allowances would be the required substitute for the current form of price subsidies.

It is clear that the USSR should be hesitant to take the lead in the economic reform process before prudently evaluating successes and failures in other socialist economies, most notably in Poland which is key country in the reform process in Eastern Europe. The long legacy of ideological confrontation implies that immediate reforms in the USSR would not fully be discounted in international capital markets. Moreover, in view of the ethnic problems in the Soviet Union, free movement of goods, capital and persons cannot be expected in the short run. This does not mean that reforms in the USSR should not be envisaged. However, only sustainable reform trajectories promise success, and it is clear that instability and political tensions in the USSR would affect the other CMEA countries, too. Furthermore, the USSR may choose to use the already more marketized CMEA countries as a natural bridge to the EC, which might actually be more feasible in the early reform stage than the direct approach to opening up the USSR to world trade.[5] Finally, a high-risk reform trajectory in the USSR would contribute to a climate of uncertainty and hence raise interest rates in world markets, when the issue of German unification and the increasing demand for capital world-wide tend to push up real interest rates. High real interest rates would have negative global repercussion effects and could entail a series of external debt crises which would affect all regions in the world economy.

A common interest shared by all CMEA countries is to improve the traffic links (especially railways and motorways) with Western Europe. After the German unification, the important EC market is closer to Gdansk than Krakow; Budapest is closer to Kiew than Leningrad, and Budapest is closer to Venice than to Moscow. This points to interesting new links between producers and consumers. Massive infrastructure investment would be useful for various reasons: (I) it would help to develop links to important Western markets. (II) it would reinforce competition by widening the radius of markets and encouraging intra-industry trade. (III) it could absorb many unemployed that would come from factory closures in the socialist industries. (IV) finally, it certainly offers profitable prospects for foreign suppliers, and it makes CMEA countries more attractive as a location for production which is tailored to the markets of both Western Europe and Eastern Europe.

It is difficult to say a priori, where the comparative advantages of the USSR and the East European countries are. Current production and export-import structures are not very informative because of the manifold distortions and the lack of transparent efficiency criteria. In the long-term view comparative advantages of a region result from the interaction of locational advantages and firm-specific advantages; hence, it will be quite important whether foreign firms can be convinced to allocate considerable foreign direct investment to Eastern Europe and the USSR. Labor intensive products will certainly reflect comparative advantages for quite some time, because marketizing the socialist economy will entail unemployment and because labor is relatively cheap. Labor productivity could be raised to West European levels in the long run, if foreign direct investment of multinationals from OECD countries would be widely accepted and mobilized.

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[5] See WELFENS, M. (1990), Internationalisierung der UdSSR? Bedeutung der sowjetischen Reformpolitik für die Stellung der UdSSR im RGW und im Ost-West-Handel, in: CASSEL, D., ed., Wirtschaftssysteme im Umbruch, München (Vahlen) 1990.

An important question concerns how visible economic progress can be achieved in the medium term, where overall problems are extremly difficult and where the legacy of high external debt (apart from the CSSR, Rumania and the USSR) gives little room for financial maneuvres. Before we address the role of the USSR, which is a special case because it is a big country with visible ethnic problems, the smaller East European countries deserve attention. These reform-oriented countries with a current per-capita income of about $ 3000 face the special opportunity every small player in world markets can enjoy, namely that its integration in the huge world market does not affect international prices in a decisive way. Hence it would not trigger off defensive or protectionist measures of major countries or country groups. With 38 mill. inhabitants Poland is already a borderline case.

Except for Rumania, the major CMEA countries have all joined the IMF (CSSR readmission is under consideration) and draw on the assistance, sometimes also on the pressure of standby agreements and the conditions fixed therein. Compared to 1981 - the onset of the international debt crisis - the debt-service ratios have reduced considerably in Poland. Interest payments plus principal repayments of long-term and medium-term debt as a proportion of hard-currency merchandise exports have fallen from 188 % to 88 % at end-1989. Hungary sufferd a slight deterioration and stands with Bulgaria at about 50 % which means that the burden of the external debt takes up every second dollar from export proceeds. Ratios of below 50 %

are desirable and might be achieved if interest rates do not increase rapidly and if economic growth in OECD countries remains around 3 percent in the 1990s. With an external debt of $ 41 and 48 bill., respectively, Poland and the USSR are the greatest debtors in absolute terms, with Hungary following with about $ 21 bill. In contrast to Poland and Hungary, private households in the USSR do not have considerable amounts of foreign currencies.

The CSSR and Hungary might revitalize valuable economic ties with Austria and Germany in the future, thus falling back into historical tracks. Both reform countries have considerable human capital which will attract foreign capital, if wage increases do not outpace productivity progress; a long-standing industrial tradition in Czechoslovakia should support a market-oriented reform approach which can be expected after the elections in June 1990. Hungary enjoys the particular benefit of being a pioneer in joint ventures. But, as yet, is has not succeeded to cope with the core problem faced by all CMEA countries: privatization of the socialist industrial sector. Apart from Germany Italian companies have set up considerable joint venture activities in Eastern Europe and the USSR, so that acquisitions and cooperative agreements in Italy are promising.[5]

Given the legacy of distortions of the command economy and the goal of a switching to a market economy based on various forms of property rights in industry, competition and price flexibility, the general tasks for reforms concern macroeconomic policies, microeconomic adjustment and external constraints.

Problems in the USSR

The USSR is clearly a decisive inhabitant of the European house. It will remain a military superpower even if the Baltic states should leave the Soviet Union. In a narrow sense, it is still a leading technological power, although its capability to translate inventions into commercially internationally successful innovations are rather limited. It would certainly like to become an economic superpower, which would be the case, if it could reach the per-capita income of Finland or Canada. Sweeping constitutional reforms have improved the prospects for decisive reform advances in the 1990s.

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[5] See THANNER, B. (1990), Direktinvestitionen in der DDR und Osteuropa: Stand und Entwicklungsaussichten, Ifo-Schnelldienst, 4/90, 7-11.

A major problem concerns opening-up the USSR to world trade. In 1988 roughly 60 percent of Soviet exports and imports concerned other CMEA countries (see Tab. 1). As the share of the German Democratic Republic was about 10 percent, the unification of Germany would reduce the CMEA-share to 50 percent and raise the share of Germany to 15 percent. By the same token, the EC's share would rise to nearly 25 percent. Japan and the U.S. were below 3 percent in 1988, but, trade between the U.S. and the USSR can be expected to increase rapidly.

Tab. 1: Regional Structure of USSR Trade, 1988 (in percent)

	Exports	Imports
CMEA (9)	58.2	61.2
GDR	10.7	10.8
other socialist countries	5.7	5.4
Developing countries	13.9	7.9
OECD countries	21.9	25.4
EC	15.1	11.6
Germany	3.8	5.1
Efta	4.4	6.3
Japan	1.8	3.0
USA	0.5	2.7
all countries	100.0	100.0

Source: Foreign Trade Statistics of the USSR/DIW, Berlin.

According to statistics of the IMF and the Deutsche Bundesbank the USSR and the other CMEA countries send about 10 % of their exports to West Germany and cover about 15 % of their import requirements in the Federal Republic of Germany. However, the absolute amount of trade between the

FRG and all planned economies (including China) is small, namely smaller than the exchange of goods and services with Austria plus Switzerland. Moreover, the export pattern is particular: About a third of West German exports concerned mechanical engineering products (15 % in total German exports) which clearly reflects the strong modernization desire in socialist economies. Capital goods amounted to about 50 percent of German exports to the USSR and the other Eastern European countries in 1988. Outward foreign direct investment which amounted to about DM 70 bill. in the period 1985-88 accrued only to an insignificant extent to socialist economies (DM 0.2 bill.).[17] This reflects a rather abnormal pattern if one compares these figures with those for intra-OECD trade and capital flows. With a unified Germany and ongoing market-oriented reforms these anomalies might change.

3. Encouraging Transition to Marketize Economies

Support for marketization and democracy in Eastern Europe and the USSR is certainly in the interest of Western countries. The reform process obviously requires politico-economic adjustments on the side of NATO member countries, where a reduced burden of defense expenditures is only one of the benefits from the sweeping changes in Europe.[18] Gains in the international division of labor, new opportunities for business and tourism as well as new avenues for policies towards development in the Third World could result.

3.1. Western Political Support

Political support for the ongoing and difficult reform process is therefore adequate for quite some time. Opening-up domestic markets for exports from these countries (most favored nation treatment) and a gradual relaxation of export controls to these countries (COCOM) will be useful. As all these countries are more or less heavily indebted and will rely on external credit for thorough reform, due attention should be paid to preserve "orderly market conditions" in international financial markets. Both the G-7 countries and the international organizations (IMF, World Bank, Bank of International Settlements) will face long-term challenges here. Western European partners of the CMEA countries will likewise be expected to perform a specific role.

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[17] See Deutsche Bundesbank, Monthly Report, 41, No. 7, Frankfurt/M. 1989, 19-25.

[18] See WELFENS, P.J.J. (1989), The Economics of Military and Peacekeeping: An Emgerging Field, Jahrbuch für Sozialwissenschaft, 40 (1989), 358-385.

3.1.1. Germany and Other EC Member States

West European countries will benefit from access to new and growing markets, but they will also have to adjust to rising imports from Eastern Europe and the USSR. Restoring full employment and regaining or preserving flexible structures of the economic system, which are the basis for smooth adjustment, is a long-term challenge faced in the EC, and, in particular, in a unified Germany.

Historically, political radicalism and instability have accompanied economic hardship in Germany. With the integration of the GDR into West Germany and the transition from a socialist system to a more productive market economy in East Germany, unemployment is expected to rise for structural reasons. 1 mill. unemployed in East Germany added to the 2 mill. unemployed in West Germany brings the total of unemployed to a dangerous three mill., where a further rise could result from a cyclical downswing in the early 1990s. For historical reasons and because of its politico-economic weight in the EC, hence Germany plays an important role in Europe.

The EC Commission emphasized in its 1988 report on the completion of the internal EC market that protectionism against third countries is not to be expected as a consequence of "EC 1992". However, the report also states that benefits and advantages of internal liberalisation and harmonization will not be unilaterally and automatically passed to third countries, unless some international commitment already exists. The CECCHINI report places emphasis on reciprocity and the rules of GATT which leaves room for discretionary action and various forms of protectionism. A "Joint Declaration" between the EC and the CMEA was signed in July 1988 which may be viewed as starting point for normalization. Quantitative trade restrictions have been removed in bilateral trades with Poland (September 1989), the CSSR (December 1988) and Hungary (September 1988), while negotiations with the USSR, Bulgaria and Rumania are pending. Various emergency financial measures have been granted to the reforming CMEA countries. However, only after adopting a series of measures, such as dismantling state monopolies, introduction of private industrial property, competition and price reforms will the EC grant trade preferences to CMEA countries (similar to those vis-à-vis EFTA countries). The best catalyst for change in EC trade policy would be high foreign direct investments from EC countries in Eastern Europe and the USSR. The export interests of multinationals' subsidiaries can generate both in the host countries and in the countries of origin of foreign capital a considerable leverage for maintaining or achieving liberal trade. Here, it is up to the CMEA countries to create a receptive politico-economic environment.

3.1.2. A Baltic Free Trade Area - BAFTA?

The process of economic reform in Eastern Europe and the USSR could be supported by a concept that would trace historical roots and take into account vital economic and ecological interests of all countries concerned. A Baltic Free Trade Area ("BAFTA") which would link the Scandinavian countries, Germany, Poland and the USSR (with a special role for the Baltic republics) could create overlapping links between some EFTA countries, some EC countries (Denmark, Germany) and some Eastern European countries. Poland, Hungary and the CSSR can be expected to apply for EC membership in the long run. Membership in EFTA (or a newly created BAFTA) could also be helpful for some countries in Eastern Europe because of free trade agreements for manufacturing goods exchanged between EC member countries and EFTA member countries.

Setting up special economic zones in the Western part of the USSR (already envisaged) would create good examples that later can be applied in a generalizing approach to the whole country. It would limit the reform risk for the Soviet Union and could help to gain expertise in a new international environment with new domestic institutions. Increasing intra-Soviet regional divergences would be the likely consequences of such a strategy, with pressure for migration towards the special zones following suit (this corresponds to observations from China in the 1980s). This in turn might distort the production process in the remaining centrally planned "core" of the USSR, but it could also be perceived as an incentive to generalize market institutions in order to restore the regional equilibrium in the Soviet Union.

3.1.3. Options for the U.S.

The U.S. could easily take advantage of the desire of East European countries to achieve a certain international balance with respect to capital inflows and trade. In principle there are various options for supporting the reform process in Eastern Europe, where fast structural adjustment, much more competition and greater macroeconomic stability are needed, while transitory unemployment cannot be avoided. Short term as well as long term measures are required. Benefits that can be expected in the longer term feed into present behavior of individuals and institutions by changing expectations in a favorable way.

If one is interested in supporting the switch to a market economy, the options are:

(1) Easing market access for firms from CMEA countries, so that improved opportunities for higher export proceeds allow a sustainable growth-cum-foreign debt-strategy.

(2) Extending directly or indirectly higher credits to reform-minded economies, so as to increase the scope for structural adjustment by reducing in the short term the burden of foreign debt accumulated under communist governments.

(3) Strengthening export capabilities of CMEA countries by encouraging U.S. and EC foreign direct investment in Eastern Europe.

(4) Encouraging regional cooperation in liberalizing trade and investment, eg by promoting the idea of a Baltic Free Trade Area (BAFTA): This could

not only generate considerable momentum for export and growth but it could also create new opportunities for industrial cooperation in central Europe. A BAFTA could also help to postpone the potentially destabilizing, conflict-prone problem of EC-enlargement in Eastern Europe.

(5) Stepping up the role of competent international organizations which bring technical and managerial expertise to CMEA countries: The International Finance Corporation (Agency of the World Bank) as well as the UNIDO (so far concerned with developing countries) could play a prominent role in this respect, and the U.S. could clearly encourage a drastic increase in activities and funding required. Poland and Hungary, respectively, are IFC member states since 1987 and 1985, but, the scope of activities launched so far is much to small to meet the tremendous challenges in supporting the transition from a socialist command economy to a market economy. Encouraging joint ventures and advising on privatization and capital market development (including entry of foreign banks) are certainly welcomed by Poland, Hungary and other CMEA countries, but this is not up to the unique transformation faced in Eastern Europe, where a shift to a market-based economy will entail growing unemployment from the start. Since demonopolization is badly needed for mobilizing the benefits of a free enterprise system guided by relative price movements and competition, a continuous challenge lies in nurturing new firms: venture capital agencies in various forms would be needed and the scale of capital required is far beyond the amounts allocated so far (IFC some $ 40 mill. and the Foreign Investment Advisory Service, a joint venture of MIGA and IFC, so far have given advice on foreign investment laws, regulations etc.).

(6) Promoting closer ties between expatriate corporate citizens and firms in CMEA countries. This option is most obvious in the case of Poland, where a strong Polish community in the U.S. offers some natural bridges for stepping up trade and investment.

(7) Supporting rapid improvements in the infrastructure of CMEA countries: Transportation and telecommunication are of utmost importance, where opportunities for competing private U.S. companies (possibly in connection with some joint venture framework) could be extremely helpful.

(8) Massive support for academic institutions dealing with the theoretical analysis of system transformation and providing consulting services for a market-oriented system. The outstanding U.S. university system offers many opportunities for long-term improvements in this area. Parallel to these short-term improvements, advice, financial assistance as well as visible encouragement are necessary.

When it comes to strategic questions of U.S. support for CMEA countries, it might be considered to first massively support those countries whose reform process is the most advanced with respect to the adoption of a free enterprise system. If the Polish reform experiment, the most comprehensive to date in Eastern Europe, can be shown to work, it will not only help to regain a politico-economic balance in Europe, but it would also point to the successful avenues for radical reforms in all CMEA countries: with a key model at hand, private capital flows to other CMEA countries will be available in the future at greater scale and - due to lower political risk premia - cheaper interest rates.

3.2. Fields of Cooperation

The pragmatic approach favored in the U.S. is quite adequate to the circumstances. However, a long-term investment horizon might be required, and joint efforts by U.S. companies to spread risks could be useful. Certainly, there will be sharp competition with Japanese companies that stand for long run investment approaches.

The service industry, in particular banking and the tourist industry, labor intensive manufacturing, suppliers of machines, equipment and know-how for energy saving and environmental improvement, and firms offering goods for improving the infrastructure are areas, where U.S. business can expect particular opportunities. In these fields cooperative agreements with Polish, Hungarian and Soviet partners might be sought on the one hand; on the other hand joint ventures seem to be feasible.[19] However, majority ownership is the key to significant foreign direct investment flows. In some high tech industries EC firms enjoy the advantage of government backing and, moreover, they can draw on considerable experience in dealings between private firms and government service industries. Clearly, the reform processes in Eastern Europe and the USSR also mean increased opportunities of foreign direct investment in the EC, where U.S. multinationals are already well positioned for closer economic links between the EC and the CMEA. Scandinavian countries might also offer an improving indirect access to Eastern Europe in the future.

The opportunities for smaller U.S. firms in Eastern Europe will remain limited if they cannot find natural allies and partners in an industrial landscape with a broad layer of smaller indigenous firms. From this perspective the type and scope of privatization in socialist economies is of key importance. The first test will be in Poland which is a key economy for the whole reform process in Eastern Europe.[20]

4. Summary and Conclusions

Certain characteristics of the socialist system create a tendency towards excess demand for factor inputs in the official economy, for sustaining shortages and currency substitution as well as growing shadow economic transactions. The transition from a distorted socialist economy to a modern market-oriented system present tremendous challenges which can be met with prudent reform policies and foreign support and investment.

As emphasized a complicated reform process is necessary and privatization, nurturing new firms, freeing prices (while according income allowances) and an opening-up process towards the economy are needed. Moreover, a new type of business behavior has to be learned, where only changing market-oriented attitudes in combination with a changing system design will provide the required growth momentum. Eastern Europe faces a historical challenge in which external support can play a positive role; U.S. government support for private investment in reform-oriented countries could contribute to sustainable income growth in the medium term, reduced risk of global debt crises and ultimately to greater stability and prosperity world-wide.

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[19] On the role of joint ventures see CSABA, L.; INOTAI, A. (1988), Joint Ventures in den Ost-West-Wirtschaftsbeziehungen, in: JACOBSEN, H.-D.; MACHOWSKI, H.; SAGER, D., eds., Perspektiven für die Sicherheit und Zusammenarbeit in Europa, Baden-Baden (Nomos) 1988, 341-351.

[20] There are various models of privatization schemes in Poland; see JASINSKI, P. (1990), "What is to be done?" A Critical Assessment of Two Models of Privatization in Poland, forthcoming in Communist Economies, 3 (2), September 1990.

Realistic reform programs that can be sustained under changing external conditions are important. The more overambitious plans are, the higher the probability that actual and expected production output will diverge, thus causing social unrest to build up. Nevertheless, a radical reform approach might be the only successful avenue in the smaller CMEA countries. However, the sequence of reforms is important for the chances of a successful reform process, in which privatization and demonopolization should be first steps.

Demonopolizing the socialist economy and adopting a more outward-oriented policy stance are additional and vital reform steps that will bring about more competition, more cost-saving innovations and thus ultimately reduced tendencies for an erosion of money's purchasing power. Competition and demonopolization will, however, pose the difficult problem of coping with potential bankruptcies. New opportunities for investment and trade are therefore urgently needed. Adjustments in the EC and the EFTA, possibly also the creation of a Baltic Free Trade Association (BAFTA) could help.

A total redesign of tax and customs laws is also required in order to obtain a property rights and incentive structure which encourages savings, investment in physical and human capital as well as a dedicated work attitude. Since in market economies technological progress accounts for about a third of economic growth, the socialist economies can prosper only if they mobilize the "Schumpeterian" dynamics of innovation and imitation of new technology. Demonopolization, competition and long-term enterprise strategies that focus on dynamic economies of scale and risky innovations are necessary ingredients to increase technological progress. A functional capital market, special venture capital agencies/firms as well as innovation-encouraging tax laws along with efficient licence imports are important elements to foster economic growth by increasing productivity.

As the risk of unemployment will be faced for the first time in many socialist economies, rising unemployment could become a decisive political shock that might lead to an abrupt halt of the reform process. A consistent strategy that matches the desired increase in labor productivity (and hence unemployment) with the opening up of new growth fields seems necessary. The required increasing integration of reforming countries into the world market is risky, because in periods of rising global protectionism the CMEA countries are in a weak position - they are hardly represented in international organizations and lack valuable experience in trade negotiations.

Fighting inflation as measured by the permanent price increase in the official or the unofficial economy would be a necessary reform ingredient in the inflation prone countries Hungary, Poland (and Yugoslavia) and other CMEA countries. Eliminating the accumulated monetary overhang and avoiding a discrepancy between monetary growth and growth of long-term output are necessary reform elements for price stability. Having restored (or introduced) convertibility a gradual orientation towards the European Monetary System might be considered as useful in the long run. Pegging the exchange rate to a low-inflation Western currency could increase the credibility of monetary policy which is especially important for central banks with low initial reputation. Even if central banks in Poland, Hungary and other CMEA countries would gain the status of a body independent of politics and with a clear commitment to price stability, the build-up of indigenous reputation would take a long time. In a situation where the fear of inflation could accelerate inflation in the short run and destabilize the politico-economic reform arrangements, the gain in reputation obtained from EMS-orientation would be particularly welcome. Certainly, in the reform process exchange rates would have to be adjusted rather frequently, but a system of fixed but adjustable exchange rates could be a vital ingredient for the growth of trade and output in Eastern Europe. If reforms would fail, massive Westward migration could not be excluded, where such a process could destabilize Western Europe. The German unification provides ample evidence of problems encountered with massive migration.

A unified Germany plays a key role in both market access and in supporting the politico-economic reform process. Moreover, German central banking provides interesting models for stability-oriented monetary policy. The most ambitious economic reforms launched in Eastern Europe concern Poland, where a sustaining success could serve as an inspiring model for the USSR.

Senator **Lieberman**. Thank you. Let me just ask you one question which is related both to what you said and to the headlines today. Is there any way in which you can imagine that a Baltic free trade area such as the one you have described could play some positive role in helping President Gorbachev, particularly, deal with his political problems with the Baltic states?

Dr. **Welfens**. Well, I think this would be a step to support Gorbachev in the sense that if he recognizes that giving greater political and economic autonomy to the Baltic republics, or even allowing them to become separate states, if he sees some short-term and medium-term economic—positive economic impact coming from such a Baltic free trade area, that certainly would encourage other members of the Soviet Union, other states of the Soviet Union, to ask for membership or to embark upon reforms that could be very similar to the states in the western part of the Soviet Union.

I would say it is very difficult to judge whether the Western part of the Soviet Union is more important than the Eastern part, but I would say if we do not take advantage of this particular historical situation, then we probably will not have another chance before decades.

And you raised the question of reversibility. I mean, we probably will not go back to the old days of the command economy, but you can expect a very different kind of chaos and stagnation. And as I see it, there are only very limited opportunities to do it.

Senator **Lieberman**. Maybe that is a serious yet hopeful note on which to end. I regret that I have to move on.

I thank you very much for your testimony. Each of you contributed enormously to what we tried to do here today, and I hope we all can keep in touch. Thank you, this concludes the hearing.

[Whereupon, at 12:34 p.m., the Committee was adjourned.]

APPENDIX

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

United States Senate
Committee on Small Business

Wednesday, March 21, 1990

Availability of Pollution Liability Insurance for Petroleum Underground Storage Tanks

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American
Insurance
Association

The American Insurance Association is a national trade organization of casualty insurers.

PROFILE

The American Insurance Association is a full-service trade organization of casualty insurance companies. In its present form, the association combines three earlier organizations. One of those, the former National Board of Fire Underwriters, was organized in 1866, making it one of the oldest trade associations in the nation.

The various departments provide members with up-to-date intelligence on legislative, regulatory, judicial and technical developments relating to our industry. The AIA also maintains liaison with insurance regulators, federal and state lawmakers, other state and federal government officials, insurance and non-insurance industry groups and media—supplying information and assistance on issues of mutual concern.

A countrywide system of regional offices and local legislative counsel ensures prompt and rigorous attention to casualty insurance matters. At the same time, technical specialists from disciplines as diverse as law, economics and engineering educate members and outside publics on developments that may affect the industry and its services to the insurance-buying public.

Pollution liability insurance coverage is generally unavailable nationwide. The inherent problems associated with gradually developing injuries to both property and persons, stringent federal and state legal standards, and misinterpretations of insurance contracts have resulted in the unavailability of most pollution-related liability insurance.

However, cleanup and corrective action associated with discharges from petroleum underground storage tanks (USTs) are considered insurable exposures by a number of specialty insurers and risk retention groups. Relative to treatment, storage, or disposal of hazardous wastes and substances, losses due to leaking petroleum underground storage tanks are manageable. In association with state trust fund mechanisms, the specialty insurance market is attempting to provide an adequate response to EPA's underground petroleum tank financial responsibility requirements.

EPA PETROLEUM UNDERGROUND STORAGE TANK FINANCIAL RESPONSIBILITY REQUIREMENTS

The Solid Waste Disposal Act (SWDA) requires owners and operators of underground petroleum storage tanks to demonstrate evidence of financial responsibility (FR) for corrective action and compensation of third parties for bodily injury and property damage caused by sudden and nonsudden accidental releases. EPA issued its final rule on these requirements on October 26, 1988.

SWDA establishes a minimum amount of financial responsibility of $1 million per-occurrence for underground storage tanks at facilities that are engaged in petroleum production, refining or marketing. Tanks not used in this fashion with a monthly throughput under 10,000 gallons must demonstrate $500,000 in financial responsibility for each occurrence.

The aggregate levels of financial responsibility are established according to the number of tanks owned: $1 million for up to 100 tanks and $2 million for an owner/operator with more than 100 tanks. EPA requires demonstration of financial responsibility through any one, or any combination of, the following mechanisms:

- financial test of self-insurance,
- letter of credit,
- surety bond,

- state-required mechanism,
- state fund or other state insurance,
- insurance or risk retention group coverage,
- trust fund.

Enforcement of the financial responsibility requirements in a state or for classes or categories of underground storage tanks within a state may be suspended if EPA determines that methods of demonstrating financial responsibility are not generally available to owners/operators in those classes, categories or states. Before suspension, EPA must be satisfied that steps are being taken to form a risk retention group for the class of tanks for which the suspension is sought, or the state is taking steps to establish a fund to provide evidence of financial responsibility for tank owners/operators in that state.

SUPERFUND LEGAL STANDARD FOR UNDERGROUND STORAGE TANKS

CERCLA's definition of "hazardous substance" excludes petroleum, thereby exempting petroleum underground storage tanks from the liability system imposed by CERCLA [Title 42 U.S.C. §9601 (14)]:

> The term does not include petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance..., and the term does not include natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel (or mixtures of natural gas in such synthetic gases).

However, Superfund requires the owner or operator of an underground storage tank to undertake corrective action "as may be necessary to protect human health and the environment." Although, "corrective action" is not well defined in the Act, allowable corrective actions "may include temporary or permanent relocation of residences and alternative household water supplies."

In addition, if the Leaking Underground Storage Tank Trust Fund incurs corrective action costs, "the owner or operator of such tank shall be liable to the Administrator or the State for such costs." The legal standard associated with the Fund's subrogation right "shall be construed to be the standard of liability which obtains under Section 311 of the Federal Water Pollution Control Act." This statutory language mirrors the definition of "liable" or "liability" found in 42 U.S.C. §9601(32):

> Liable or liability under this subchapter shall be construed to be the standard of liability which obtains under Section 1321 of Title 32.

CERCLA case law has determined that the Superfund liability standard is strict, and may be joint and several, depending upon the fact situation.

Under joint and several liability, each defendant is liable for all damages rather than being liable only for the defendant's contribution to the cause of the damages. Joint and several liability creates the possibility that a policyholder's liability will bear no relationship to its conduct. A policyholder's premium is based on the insurer's perception of the activities engaged in by the specified insured. Insurance policies are not issued with the intent of covering conduct of persons not party to the contract. Due to the application of joint and several liability, the insurer is faced with the possibility of providing coverage for which it receives no premium.

Supporters of the use of joint and several liability believe the standard is appropriate for most CERCLA cleanups because wastes have been comingled, and it is difficult to establish a reasonable basis for division according to the contribution of each. However, what may appear to be good public policy may, at the same time, be extremely difficult to insure.

The Superfund Amendments and Reauthorization Act of 1986 (SARA) amends Section 9001 of the SWDA to mandate that the owner/operator of underground storage tanks will be required to maintain "evidence of financial responsibility for taking corrective action and compensating third parties for bodily injury (emphasis added) and for property damage...."

State and federal statutory law and common law in the area of toxic tort bodily injury have responded to the vagaries of toxic tort causation by expanding the use of medical presumptions, applying strict, joint and several liability, creating retroactive liability, constructing new damage theories and eliminating or reducing defenses. A regimen of toxic tort bodily injury damage concepts may be requested by claimants and their attorneys merely upon a showing of exposure to a toxic substance. However, petroleum discharges are much less likely to result in non-traumatic, long latency diseases than are discharges of toxic chemicals, and the number of toxic tort bodily injury claims associated with discharges of oil is likely to be limited.

A menu of damage theories, including enhanced risk of future harm, mental anguish, immunotoxicity and medical monitoring, is available to the toxic tort claimant. In many instances, all of these damage theories are alleged by plaintiffs in a single action. In addition, the amalgamation of these new toxic tort causes of action with the use of epidemiological data to prove or disprove causation has resulted in awards for injuries which may occur decades in the future or which may never occur.

A vast majority of insurers will not provide coverage for corrective action associated with the insured's own property. Fortunately, the petroleum UST specialty insurance market has chosen to provide coverage for on-site cleanup. A majority of general liability policies and pollution liability policies contain an exclusion which states that the insurance does not apply to damage to property owned or occupied by or rented to the insured, property used by the insured, or property in the care, custody or control of the insured or as to which the insured is for any purpose exercising physical control. This exclusion is designed to create an incentive for responsible on-site management by the policyholder so that the potential for off-site bodily injury and property damage is minimized.

Courts have been inconsistent in their interpretation of the "own-property exclusion" when on-site abatement remedies may be designed to prevent imminent damage to third parties. To the extent that all or a portion of the response expenses pertain to the prevention of off-site contamination, the own-property exclusion has not been consistently interpreted. It is problematic as to whether the cost of preventive measures taken by the insured on its own property which are designed to disallow or abate the continued release of pollutants onto adjacent lands falls within the policy coverage.[1]

CURRENT INSURANCE MARKET FOR UNDERGROUND STORAGE TANKS

A specialty insurance market has developed in response to the underground tank financial responsibility requirement. However, this specialty market does not have the capacity to respond to the insurance needs of all small owners/operators on a nationwide basis, and other methods of responding to the requirements are not available to most small owners/operators because they are contingent upon large cash reserves, e.g., letters of credit, or are traditionally not designed to respond to liability exposures, e.g., surety bonds. A vast majority of medium and small owners/operators will be unable to utilize the alternative methods for demonstrating financial responsibility because they are more expensive than insurance, do not transfer risk, and may require assets to be pledged beyond the resources of the owner or operator.

Most of the available insurance coverage for pollution liability associated with petroleum underground storage tanks is offered by relatively new insurers, rather than the traditional property/casualty insurance market. Coverage may vary by state by insurer. Some UST insurers are willing to construct policies which provide needed protection not offered by the trust fund mechanisms but required by EPA, e.g., coverage for third party bodily injury and property damage or on-site cleanup. Coverage, while accurately priced, may be considered expensive for small owners/operators. Some insurers and risk retention groups will provide coverage only in states which have trust fund mechanisms, while others may provide coverage only in states without a trust fund mechanism. Many of the risk spreading mechanisms providing underground storage tank pollution liability coverage write in a limited number of states.

The Insurance Services Office (ISO) plans to develop an underground storage tank liability form along with proposed insuring considerations which will lead to underwriting requirements. However, it must be stressed that the development of a form and prospective loss costs does not indicate that traditional property/casualty insurers will offer the coverage.

ISO is an all-industry rate advisory organization that, pursuant to state regulatory authority, develops forms and prospective loss costs for voluntary use by other companies. The ISO program will include a separate Coverage Part specifically designed to cover owners or operators of petroleum underground storage tanks. The UST Coverage Part will be designed to meet the needs of insureds in satisfying the financial responsibility requirement. Coverage will be for liability arising out of the release, escape or leakage of stored petroleum substance from an insured UST, and for corrective action required by governmental authority. The policy will be on a claims-made basis.

ISO's current schedule contemplates review of the proposed program by appropriate insurer committees during March 1990, and submission of filings to regulation for an October 1, 1990 effective or distribution date.

A survey of the current market indicates the following insurers or alternative risk spreading mechanisms provide tank coverage:

Agricultural Excess & Surplus Company (AESIC)

AESIC offers a claims-made policy specifically designed to meet EPA requirements in all states except Delaware, Maine, New Hampshire, Rhode Island and Vermont.

American International Group (AIG)

AIG offers both a general insurance program and pollution liability insurance. AIG's insurance policy does not respond to all aspects of the RCRA UST financial responsibility requirement.

Anglo-American Insurance Company and Walbrook Insurance Company, Ltd.

Offers pollution liability insurance; currently writes in all states except Rhode Island and Massachusetts.

Evanston Insurance Company

Currently writes pollution insurance for petroleum tanks only in Illinois, Indiana and Wisconsin; intends to expand. Does not insure petroleum marketers; specializes in policies for small cities and townships and other governmental entities.

Environmental Impairment Purchasing Group, Inc.

Pollution liability insurance written through Presidential Fire & Casualty. Not available in all states.

Federated Mutual Group

Market:	Aboveground and underground storage tank owners and operators, petroleum and non-petroleum

Limits:	$500,000/$1,000,000
Deductible: (minimum)	$25,000
Defense Costs:	Outside limits of liability
Coverage:	Claims-made, 6 month term On-site/off-site cleanup, third party bodily injury/property damage

The Oilmen's Insurance Plan

Market:	Petroleum jobbers and wholesalers
Limits:	$500,000/$1,000,000
Deductible: (minimum)	$10,000
Defense Costs:	Included in limits of liability
Coverage:	Claims-made, on-site/off-site cleanup, third party bodily injury/property damage

Oilman's Insurance writes in the following states: Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Idaho, Illinois, Kentucky, Maine, Maryland, New Hampshire, New Jersey, New Mexico, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Vermont, Washington and West Virginia.

Front Royal Group, Inc.

Its principal business is that of underwriting specialty pollution insurance coverages, initially on underground petroleum storage tanks at service stations and other locations. The coverage is designed to inable the policyholder to comply with the financial responsibility requirements for petroleum underground storage tanks mandated by the Solid Waste Disposal Act.

The Front Royal Group offers policies in the District of Columbia and 14 states: Alabama, Georgia, Illinois, Indiana, Kansas, Maryland, Missouri, North Carolina, Oregon, South Dakota, Texas, Utah and West Virginia.

Recent developments associated with the Environmental

Protection Insurance Company (EPIC) and the Petroleum Marketers Mutual Insurance Company (PETROMARK) suggest the volatility of the UST pollution liability insurance marketplace. EPIC, an approved risk retention group, has recently ceased to do business because it could not attract sufficient policyholders. PETROMARK, an approved risk retention group, recently announced that it will discontinue seeking new business and will renew policyholders on an extremely limited basis because its actuaries have reported that it is seriously underreserved. A second actuarial examination is currently underway.

STATE UNDERGROUND STORAGE TANK TRUST FUND MECHANISMS

Recognizing the shortfall of insurance capacity, forty-one states have enacted laws, many during the last two years, which create underground storage tank trust funds. These are:

Alabama
Arizona
Arkansas
California
Colorado
Connecticut
Delaware
Florida
Georgia
Illinois
Indiana
Iowa
Kansas
Louisiana
Maine
Michigan
Minnesota
Mississippi
Missouri
Montana
Nebraska
Nevada
New Hampshire
New Jersey
New Mexico
New York
North Carolina
Ohio
Oklahoma
Oregon
Pennsylvania
South Carolina
South Dakota
Tennessee
Texas
Utah
Vermont
Virginia
West Virginia
Wisconsin
Wyoming

Some of these enactments respond to RCRA UST financial responsibility limits of $1 million per-occurrence and provide coverage for corrective action, and in some instances, third party bodily injury and property damage. All of these recently enacted laws contain a self-retention level in varying amounts, with $100,000 as the most frequently chosen level. Funding for the response funds may include taxes, fees, premiums and cost recovery.

EPA is currently evaluating these recent enactments to determine whether they meet the regulatory requirements for underground tank FR requirements. Some funding mechanisms may not fully respond to the UST financial responsibility requirement. Several states are amending their existing UST trust fund laws in order to comply with RCRA UST requirements. Some trust fund mechanisms may be undercapitalized, and a number of the funding mechanisms may not yet be operational.

CONCLUSION

The availability of insurance to service the petroleum underground storage tank financial responsibility requirement legislated by SARA is limited. Insurance capacity is expanding, and a majority of states have enacted trust fund mechanisms intended to respond to UST financial responsibility requirements. However, it is problematic as to whether the state trust funds, supplemented by private sector insurance, can respond to the needs of all small businesses.

Respectfully Submitted,

James L. Kimble
Senior Counsel

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1. See Broadwell Realty Services, Inc. v. Fidelity and Casualty Co., Superior Court of New Jersey, Appellate Division, A-5301-8577, July 2, 1987, in which gasoline escaped from several underground storage tanks on the policyholder's premises and migrated onto adjacent lands. The judge reasoned that Broadwell's cleanup efforts were designated to "mitigate damages" that would otherwise be owed to adjacent property owners and that the amounts expended in that regard were compensable under the policy even though the policy included the "own-property" exclusion.

   Summit Associates, Inc. v. Liberty Mutual Fire Insurance Company, No. L-47287-84, Superior Court of New Jersey, February 25, 1987, in an avowedly result-oriented discussion, the Court rejected application of the own-property exclusion. The Court repeatedly appeared to concede that the exclusion plainly applied to the removal of waste from Summit's property. However, stating "the health, safety and welfare of the people of this State must outweigh the express provisions of the insurance policy in issue," (emphasis added) the Court held that the exclusion is simply not applicable where the important public policy in favor of clean-up of toxic waste is implicated. The Court then awarded attorney's fees and prejudgment interest to Summit, stating "the equities of the present case support an award of prejudgment interest, despite the fact that Liberty had a valid basis for denying coverage." The decision has been overturned at the appellate court level.

JLK/chh/0326I

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March 22, 1990

Small Business Committee
United States Senate
Washington, D.C. 20510

Dear Senators:

On behalf of Alascom, Inc. (Alascom), the attached statement of C. Lee Wareham, Alascom's Vice President, Operations, is submitted as part of the record concerning developing business relations between the U.S.A., Eastern Block countries and the U.S.S.R. Alascom is pleased and honored to offer this contribution for the Committee's consideration.

Alascom is the dominant interstate, and the only authorized intrastate, telecommunications long-distance carrier for the State of Alaska. Alascom is charged with the duty of serving every Alaska community of 25 or more persons. Alascom's network, which includes over 200 satellite earth stations and extensive terrestrial facilities, is one of America's great technological achievements. It offers a full range of intrastate, interstate and international communications services to all Alaskans.

In 1989, Alascom sought and received authority to extend its network to the U.S.S.R. Last August, it put into service a 12 channel radio-based telephone link across the Bering Strait, interconnecting Gambell, Alaska and Provideniya, Magadan, U.S.S.R. That link, which is 56 miles long, is the first, and to date only, direct terrestrial telephone connection between the U.S.A. and U.S.S.R. It currently allows operator-assisted calling between all Alaska locations and the Magadan region.

Alascom is proud to offer direct telephone interconnection with the U.S.S.R. and hopes to expand the existing facilities gradually. Alascom believes that affordable, reliable communications will be a foundation for peaceful cultural exchange and business development between Alaskans and their neighbors in the Soviet Far East. With communications come progress.

The Gambell-Provideniya telecommunications link and the history leading up to it are more fully explained in Mr. Wareham's statement, attached hereto.

If the Committee would like further information, please communicate with Mr. Wareham or the undersigned.

Very truly yours,

Charles R. Naftalin

DIRECT TELECOMMUNICATIONS - ALASCOM/USSR

Alascom's direct involvement with the USSR began in late 1987 when we were asked by the United States Information Agency to participate in a Satellite Telecommunications Seminar in Tiblisi, Soviet Georgia. The program began with three days in Moscow where the U.S. Embassy arranged for the participating companies (Comsat, Home Box Office, the Learning Channel) to meet with appropriate Soviet Ministries to discuss business interests.

At the beginning of the Seminar in January of 1988, we met with Gostelradio (Soviet Radio and TV), Intersputnik (The East block analogue of Intelsat), and the Ministry of Posts and Telecommunications. In each case, my presentation included the fact there were stirrings of interest on both sides of the Bering Sea in business and cultural contacts between the two regions, that these types of relationships couldn't flower without good direct communications between the two, and furthermore, since we were next door neighbors (2.4 miles between Soviet Big Diomede Island and U.S. Little Diomede), we should act like neighbors. We wanted to begin the process of establishing direct telecommunications links between the Magadan Region of the Soviet Far East and Alaska.

Without exception, all three Ministries were taken by surprise by my approach, but all were interested and asked to be kept informed as events unfolded. All wanted to work with us.

By late February of 1988, things began to move in Alaska and Magadan toward a concrete first step in thawing the 'Ice curtain'. A "Friendship" Flight was being planned that would take an Alaska Airlines 737 to Provideniya (some 250 miles from Nome across the Bering Sea) with 85 Alaskans on board for a one-day visit. Included would be Alaska Natives, political figures, and business representatives. Target date was April 18.

No one on either side knew how to organize a trip like this. It was trial and error. The governments on both sides were supportive but the April date came and went. A new date in June was settled on. Coordination was difficult between officials in Alaska and Magadan because even though they were next door neighbors, as distances in the Far North go, phone calls had to go all the way around the world--First to the Continental U.S., then across the U.S., then across the Atlantic, then across Europe to the U.S.S.R., then clear across the entire width of the vast Soviet Union - almost back to where the call started. It took hours or days and cost a fortune.

In spite of delays, the visit began to firm up for mid June. In early May, Alascom was asked if we could provide live radio and TV coverage of this historic event. My answer was "it's technically feasible for us to take one of our transportable satellite communications stations to Provideniya and send back radio and TV programs, as well as telephone calls on Alascom's Aurora Satellite (which, because of Provideniya's proximity, has a good signal there, but administratively, the chances are small to none we could get authority from both governments in time".) We were urged to try, and somewhat dubiously, agreed. My personal opinion was, we'd learn from the process and eventually, for some subsequent event, actually pull it off.

To my surprise, the obstacles fell away one by one. The governments of both the U.S.S.R. and the U.S. worked minor miracles to bypass roadblocks. Twelve hours before our scheduled departure from Anchorage, the actual flight authorization for our two aircraft arrived from Moscow. Early in the morning of June 11, 1988, Alascom's Beechcraft King Air and a Mark Air C-130 Hercules left Anchorage for Nome. After refueling there, the King Air headed for Provideniya with the C-130 to follow an hour later. This would give us time to work with Soviet Airport officials and help the 130 land in spite of atrocious weather. Fog, rain, and snow, +31°Fahrenheit, and three miles visibility were reported at Provideniya. We didn't have approach plates or proper charts of the area. They simply weren't available from western sources. When we met the Soviet Navigator who would accompany the Alaska Airlines 737 in Nome, he was asking our pilots what they knew about Provideniya. He had no more information than we did. Our pilots who would be returning later in the day promised to give him a briefing on actual observed operating conditions before he and the 737 were due to leave the next day. He was obviously relieved.

The King Air's actual approach to Provideniya was made at low altitude in terrible weather using onboard radar and Soviet radar vectors. None of the English speaking Air Traffic Controllers were on scene yet. (The same bad weather that was bothering us had trapped them for three days at Anadyr some 300 miles to the Southwest.) Despite language difficulties, we landed on the first pass. The C-130, after one missed approach, with the help of our pilots and Soviet Air Traffic Controllers, got down without incident.

After an initial inspection of the operating location our Soviet colleagues had picked for us downtown, we immediately went to work setting up the station. Soviet support and cooperation was great. The operating location was ideal. When we needed a crane and heavy concrete blocks to anchor our antenna in rising wind, we got them--immediately. Hundreds of people watched us work through the night.

We were on the air with Alaska a little after 2:00am Provideniya time. Everything went as planned. Live TV, radio, and press dispatches poured across the Bering Sea. The press room with ten telephones off the Anchorage telephone system amazed everyone. The Friendship visit itself arrived on schedule, thanks to a break in the weather. It was by all accounts a resounding success. Eighteen hours after departure of the Friendship Flight for home, our two aircraft returned to Provideniya to pick up the seven of us and our equipment. We were exhausted but jubilant. We had accomplished everything we set out to. Cooperation with our Soviet neighbors was a reality. Georgi Perov of the Soviet News agency "Tass" told me, as we were leaving, that the local people, on seeing us work for 2 & 1/2 days with only 2 two-hour sleep breaks and 3 meal breaks, were saying "If Soviets worked like Americans, we could do a five-year plan in 2 years". I'll always treasure that.

After the Friendship Flight the kettle really began to boil with activity across the Bering Strait. We did engineering feasibility studies and developed a list of options for tying the two regions together. Based on demonstrated feasibility, the best way seemed to be by direct satellite link. There was at this point no specific person or organization to work with on the other side.

In October of 1988, a delegation from the Governor of Alaska's Office of International Trade went to Khabarovsk and Vladivostok in the Soviet Far East by way of Japan. Included in the delegation were representatives of Alaska Airlines, Alaska Commercial Company, the Alaska Miners Association, Alaska Joint Ventures Seafoods, Alascom, and the Governor's Chief of Staff. In addition to signing a sister state agreement with Khabarovsk Territory, we met with business representatives from our respective fields. One of those I met with was a man who was billed as a "Communications engineer from Magadan". That he was, but he was a lot more as well. Vladimir Silchenko was head of the Post and Telegraph organization for the whole territory. With the aid of a young lady interpreter who knew nothing of telecommunications, some sketches on notebook paper, and an almost instantaneous personal rapport, we very quickly hashed out a basic approach to direct communications ties. It wouldn't be satellite to start off with. In the interest of simplicity, it would be multi-channel UHF radio.

During the ensuing weeks, while his technical staff and ours worked on details, we also tackled the administrative and regulatory aspects.

In February of 1989, a plane load of Soviet visitors from Magadan arrived in Anchorage. It was the return of the Alaskan Friendship visit. Our Soviet guests stayed not eight hours, but a whole week, most of them in private homes with their American hosts. Vladimir was among the delegation.

During the week he met with us and we finalized the details of our communications link. We'd start modestly with a 12-channel UHF radio link between the village of Gambell on St. Lawrence Island and Provideniya. The 56-mile system would tie into our existing satellite station in Gambell and the Soviet Tropo-scatter system on their side. Target date for system turn-up would be mid July.

As it turned out, weather delays in tower construction at Gambell caused a one-month slippage in placing the new system in service. On August 25th, calls actually began to be passed back and forth. The two neighbors were now truly next door.

At the same time we began to work on revising the rates for calls in the "neighborhood".

Where formerly it had cost $15.00 for a 3-minute call with a three-minute minimum, the new rate was $2.80 for a 3-minute call. Rates were, on the average, the same as for a similar distance from Alaska to points in Canada.

There is still a quality problem because of the obsolete technology employed in the Magadan Region. Their equipment is similar to what we had in service in Alaska in the 1950's.

Our present agreement with the Magadan Territorial Board of Communications is a relatively simple international carrier agreement. In addition, we have both signed a letter of intent to establish a joint venture to provide special communications services not normally within the scope of an international carrier agreement. An example would be a remote mining operation jointly being developed by U.S. and Soviet enterprises. When such facilities are developed in Alaska, we provide for their communications needs under contract. The same would be true for a similar development in the Magadan Region, only this time the customer would want to be tied into both the Soviet parent enterprise and its Alaskan counterpart.

We are interested in the improvement of communications in the Soviet Far East because we see, long term, the possibility of greatly expanding Alaska's and Alascom's role as the U.S. telecommunications gateway. We have a modest tie between us at the moment, and facilities on the Soviet side leave much to be desired. This is, however, a long-term relationship. We have long-term objectives. Already we can see the difference low cost, ready access to our neighbors has made. Communications lubricates the machinery of commerce, trade, and cultural exchange.

As ties of all kinds grow between Alaska and the Soviet Far East, we will be participants. Not just because it's good business, which long term it almost surely will be, but because it's a way for us to participate as a corporate citizen in improving international relations. To that end we work closely with the State Department and other U.S. governmental agencies to assure our efforts are in accordance with U.S. policy and objectives.

We believe this process, if properly done, is a winner for all concerned. It also is both satisfying and exciting for those of us who participate directly. We now have friends and colleagues in an area we only a short time ago considered enemy territory. Whether by design of our central governments or by accident, the people-to-people diplomacy between the Soviet Far East and Alaska is, so far, a solid success.

C. L. Wareham

/lm

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Finance and Debt in East-West Relations
Policy Challenges in an Era of Change

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I. The Policy Environment

Changing Priorities for National Security

U.S. national security concerns in East-West relations are undergoing profound changes. Traditional worries about flows of capital and technology to the East have not disappeared, but new priorities have emerged. Recent startling and unexpected political changes now hold promise of an elimination of the communist monopoly on power; political pluralism is emerging in four major East European countries--Poland, Hungary, the GDR and Czechoslovakia. And while political pluralism in the Soviet Union does not seem imminent, the changes being introduced by President Gorbachev appear to be leading to significant changes in Soviet domestic and foreign policies. Taken together, these developments point to a reduction in East-West tensions and the beginning of a new era in East-West relations.

There are clear reasons why the United States and the allies should seek to foster such trends, because such changes serve to enhance western security. Put another way, there would be adverse consequences for western security if the economic and political changes underway in many Eastern European countries should fail for lack of adequate support from the developed world. But not all reforms can be expected to work and the possibilities of setbacks or even Chinese-style reversals are evident.

Differentiating among the many efforts at reform, weighing the associated prospects for success of each and determining how best to help is a daunting task--one that has so far received little serious attention in the West. While the West has had over forty years to learn how one acts in the context of the "cold war" relations, the rapidity of change in Eastern Europe is transforming East-West ties before new institutions and structures to mediate relations in the new environment are in place.

The Financial Times, for example, recently reported that Jacques Delors, the president of the European Commission (which has been assigned the role to coordinate loans and aid to Poland and Hungary), was startled to discover before his first trip to Hungary in November 1989 that the EC had no representative in Budapest [1]. The purpose of Delors' trip was to finalize details of a ECU 1 billion loan ($1.2 billion), the first loan ever to a country outside the EC. Without effective on-the-scene monitoring, the special conditions attached to the loan--above and beyond the usual IMF conditions--lack credibility [2]. **The Wall Street Journal**, meanwhile, reported U.S. government concerns that the $8 billion in loans and other grant aid being discussed for Poland and Hungary may lack proper coordination and organization [3].

The Role of Finance and Debt

New western initiatives toward the East have a common denominator--they all cost money. Since the political changes in the East spring from economic crises, resources must be found to underwrite such political changes and bolster their legitimacy. Until new economic structures are created and put into place which can provide the economic gains that have been lacking, money and other economic concessions in the fields of trade and investment will be essential.

A key policy issue for western countries is to determine the desired scope and terms and conditions of future resource flows to the East. Restrictions on resource flows would presumably be retained in countries where desired political changes are lacking, e.g. China and Rumania. In other countries, however, the challenge now is to use western resources to help facilitate the political transition now taking place. There are two priority goals: 1) short-term economic stabilization -- to cushion the initial impact on living standards of the economic dislocation associated with political change; and 2) transformation of the economic system into one where state ownership and control is substantially reduced in favor of an increased role for private property and markets.

How can the West use its economic resources to best advantage to promote desired political changes in the East? And what sort of balance is appropriate between public initiatives and private-sector activities? These questions highlight two critical linkages which will determine the success of future policies: 1) the connection between western economic assistance and political developments in the East, and 2) the interplay of private and public interests in East-West relations.

The role of international debt and financing is central to both issues. New financing and the management of the existing debt will play a key role in western assistance policies. One major issue that awaits better definition is the appropriate mix and coordination of bilateral and multilateral credit. And since approximately 50 percent of the existing $190 billion of debt owed by the East is held by commercial banks, the evolution of private strategies in regard to the debt are central to western policies defining desired resource flows to the East. A related issue is whether western governments should offer private banks inducements such as credit or investment guarantees in order to encourage their lending to priority countries.

A final consideration with regard to financing is how it is used. This brings in the knotty issue of conditionality. Given all that is wrong with the economic systems and policies in the East, how do we ensure that new resource flows are used efficiently? After all, the $190 billion in existing debts failed to bring adequate improvements in economic performance and living standards, despite the borrowers' past good intentions. Why should we expect that an additional $10-20 billion in new money will bring radically different results? And if policy shortcomings on the part of the new governments are evident, what then--a suspension of new lending?

Before exploring these issues, the debt situation in the East is reviewed.

II. Overview of the Debt

The State of Creditworthiness in the East

The total debt of Eastern Europe, the Soviet Union and China is estimated to have grown from approximately $105 billion at the end of 1981 to $188 billion at the end of 1988. In order to provide a perspective on the burden represented by such debts, Table 1 presents data on the net-debt-to-export ratio for each country. This ratio is a convenient measure of a country's total debt, net of hard currency reserves, compared with the country's earnings from sales of exports and services for hard currencies which is available to service the debt. As a rule of thumb, any ratio over 2.0 indicates an excessive debt burden (with a high probability of default and rescheduling), while a ratio below 1.0 indicates a modest debt burden. In order to draw any overall judgement on creditworthiness though, these data must be supplemented with other information on a country's domestic economic policy and performance.

During the 1981-88 period, three of the countries were forced to reschedule: Poland in 1981, Romania in 1982 and Yugoslavia in 1983. Poland was unable to generate sufficient foreign exchange to service the interest on its debt, and as a result its total debt rose from $25 billion to $38 billion as interest arrears (primarily to government creditors) accumulated and were converted into new loans. Although interest service on debt owed to commercial banks continued current until September 1989--when the new Solidarity-led government defaulted on these obligations, only a few new trade-related credits from banks were forthcoming.

TABLE 1

NET DEBT TO EXPORT RATIOS FOR EASTERN EUROPE, CHINA AND 15 HIGHLY INDEBTED COUNTRIES

	NET DEBT TO EXPORT RATIO*		1988	
	1981	1988	GROSS HARD CURR DEBT $ Millions	NET HARD CURR DEBT $ Millions
USSR	0.36	0.66	43000	28195
BULGARIA	0.63	1.56	7810	6032
CZECHOSLOVAKIA	0.76	0.62	5520	3848
GDR	1.54	0.60	20730	7572
HUNGARY	1.16	1.80	17349	13880
POLAND•	4.61	4.21	35470	37497
ROMANIA	1.21	0.12	1931	1122
YUGOSLAVIA	1.16	0.89	18683	14296
EASTERN EUROPE	1.03	1.04	150493	112442
CHINA	-0.20	0.24	35020	10929
15 HIGHLY INDEBTED COUNTRIES	1.77	2.73	470700	437200

* Debt to Export Ratio is defined as: Net Hard Currency Debt divided by Hard Currency Current Account Receipts.

•Poland ratios actually 1982 and 1987 respectively.

Sources: PlanEcon, Trade and Finance Review (July 1989); IMF, World Economic Outlook (Oct. 1989).

Banks do not view Poland as creditworthy; thus, the prospect of new bank lending in the foreseeable future is slim. The key issue with regard to the bank debt is whether a Brady-type debt reduction agreement is feasible. Since banks account for less than 25 percent of the total debt, any agreement along the lines of Mexico's debt reduction bonds would have to be accompanied with comparable debt reduction from official creditors, who hold the bulk of the debt. Alternatively, Poland may be able to use resources from multilateral institutions and governments to buyback bank loans or provide 100 percent guarantees on any debt reduction bonds the banks may be asked to accept. European banks, especially German banks, may be expected to take the lead in discussions with Polish authorities on these issues.

By contrast, Romania ran current account surpluses during these years and paid down its debt, reducing total debt from over $11 billion to under $2 billion and eliminating all long-term loans owed to commercial banks. Romania has announced its intention to avoid new borrowings in the future. The costs of this policy of export-at-any-cost, though, have been severe on the domestic economy. Thus, although Romania is unlikely to borrow in the foreseeable future, banks would also be reluctant to extend new term loans to the country. Bank activity is restricted to modest short-term financing lines.

Yugoslavia was able to service all interest obligations, thanks to continuing current account surpluses and modest amounts of new money from banks and governments. Total foreign debt stabilized during 1984-87 and during 1988-89 a marked decline in debt was achieved as net repayments were made to the IMF and World Bank and bank debt was reduced via debt-to-export conversions and buybacks.

Although Yugoslavia's debt burden has dropped in impressive fashion during recent years, banks remain reluctant to extend new credits. In large part this is due to the worsening domestic political and economic situation in the country. Inflation has surpassed even Brazilian levels and is now running at over 40 percent per month. Meanwhile, domestic political squabbles among the republics appear to be worsening.

Yugoslavia's debt burden cannot be considered high and most banks do not believe that debt reduction by itself will help solve current problems. Yugoslavia clearly cannot continue on its present course; domestic economic stabilization is needed and the impetus for such reforms must come from within Yugoslavia itself. Given such reform initiatives, it would be up to western governments to respond with assistance appropriate to the circumstances, e.g. IMF and World Bank programs, and rescheduling and new money from the Paris Club governments. The appropriate role for commercial banks with regard to the debt could only be defined after these key components are in place.

All the other Eastern European countries and China retained access to international credit markets during this period. Several distinct patterns are evident in these countries' debt-to-export ratios. Hungary and Bulgaria, for example, saw rapid rises in their debt ratios as new borrowings far outstripped export growth. Both countries were able to tap new financings, though as the ratios approached the "danger" zone, it has become increasingly difficult to raise new loans. Indeed, many bankers consider Hungary a candidate for rescheduling; were it not due to the substantial support being received from West Germany and the EC, Hungary would likely have been forced into rescheduling by now.

The remaining countries -- Czechoslovakia, the GDR, the Soviet Union and China -- have successfully maintained debt-to-export ratios in the moderate range. The trend in the ratio has generally shown a tendency to fall during 1981-84, followed by a modest rising trend. With the exception of China, these countries enjoy relatively free access to international credit markets.

China's access to international credit was severely curtailed after the government's crackdown on the pro-democracy movement in June 1989. Although several small syndicated credits were arranged for Chinese state companies since then, Japanese banks -- by far the largest lenders -- have been conspicuous by their absence in such deals. New lending from the World Bank and the Asian Development Bank have also been put on hold. Future bank lending to China will closely mirror western governments' own policies. When the loan windows at the World Bank and ADB reopen, banks are apt to begin a cautious renewal of term lending. It seems doubtful, however, that such lending will match past trends.

Evolving Patterns of Bank Lending to the East

A new perspective on the debt is gained when these same data are disaggregated by creditor groups. Table 2 provides a breakdown of the debt for 1981, 1984 and 1987 by major creditor group-- official bilateral (government), commercial banks, multilateral institutions and other (mostly supplier credits).

The claims of commercial banks rose about 25 percent in nominal terms (excluding China). The commercial bank share in total debt declined only moderately, from 59 percent to 53 percent of the total. The share of official bilateral claims in the total rose modestly during this period from 25 percent to 29 percent and a similar increase took place in lending by the IMF and World Bank -- from 2 percent to 6 percent of the total.

TABLE 2

Estimated Distribution of East European Debt By Category of Lender

(percentage share of total)

	1981	1984	1987
USSR			
Official & Guaranteed	61	64	37
Unguaranteed Banks	29	34	59
IMF/BIS World Bank	0	0	0
Other (1)	10	2	4
Bulgaria			
Official & Guaranteed	21	46	29
Unguaranteed Banks	71	53	70
IMF/BIS World Bank	0	0	0
Other (1)	8	1	2
Czechoslovakia			
Official & Guaranteed	17	35	35
Unguaranteed Banks	73	63	61
IMF/BIS World Bank	0	0	0
Other (1)	11	2	5
GDR			
Official & Guaranteed	17	38	28
Unguaranteed Banks	66	53	58
IMF/BIS World Bank	0	0	0
Other (1)	16	10	14
Hungary			
Official & Guaranteed	6	12	9
Unguaranteed Banks	88	66	63
IMF/BIS World Bank	0	12	9
Other (1)	6	9	19

(cont.)

TABLE 2 (cont.)

Estimated Distribution of East European Debt By Category of Lender

(percentage share of total)

	1981	1984	1987
Poland			
Official & Guaranteed	42	42	45
Unguaranteed Banks	36	24	24
IMF/BIS World Bank	0	0	0
Other (1)	22	34	31
Romania			
Official & Guaranteed	14	19	18
Unguaranteed Banks	47	30	35
IMF/BIS World Bank	17	35	34
Other (1)	22	16	13
Yugoslavia			
Official & Guaranteed	18	31	26
Unguaranteed Banks	53	38	41
IMF/BIS World Bank	16	22	21
Other (1)	14	11	12
China			
Official & Guaranteed	22	36	22
Unguaranteed Banks	51	27	58
IMF/BIS World Bank	9	9	14
Other (1)	18	28	6

1. Debts to non-OECD countries (including intra CMEA debts), intra-German debts, a forfait credits and unguaranteed supplier credits.

Source: Financial Market Trends - OECD (February 1989), p.35; World Bank, World Debt Tables.

Disaggregation of these data by creditor is possible only for claims by commercial banks, and for 1981 such data is only available for five countries -- fortunately the key countries. The data are taken from individual country reports to the Bank for International Settlements [4]. Several important caveats must be kept in mind when reading the Charts. Data for Japanese banks include only medium and long-term exposure, thus understating the overall exposure. If the maturity structure of Japanese bank lending is similar to that of other banks, then the understatement is substantial -- at end-1988 short-term claims (less than one year) of all banks accounted for 32 percent of total claims on Eastern Europe and China.

A second problem concerns the 1981 data. The exposures of German banks do not include a substantial volume of claims booked in Luxembourg, thus outstandings on that date are understated. The 1988 data do include these exposures. The comparison of 1981 and 1988 exposures of German banks, therefore, overstates the actual expansion of such lending. A final caveat is that loans, bonds and private placements held by non-banks are not included in the data; such lending activity has been significant for Japanese institutions (life insurance and leasing companies), especially in Hungary, the GDR and the Soviet Union. The data used to generate the charts are shown in an Appendix Table.

The aggregate data, shown in Charts 1-3, tell a story of substantial divergences in bank lending strategies in different countries. Since both Poland and Yugoslavia rescheduled their bank debt, declines in claims most probably represent net sales or write-offs of such debt [5].

- Although U.S. banks were quite active in lending to Eastern Europe in the seventies, there was a sharp reversal in their activity after 1980. In 1988, U.S. banks accounted for only 3.4 percent of total claims, and if lending to Yugoslavia is excluded, the U.S. share drops to 1.7 percent. A similar, though less marked, shift is evident for the U.K. banks.

By contrast, German and Japanese banks have expanded their lending dramatically. Such lending was concentrated in Hungary, the GDR and Bulgaria, where German and Japanese banks are the leading creditors, and in the Soviet Union, where French banks hold the leading position (see Charts 4a-4h). As may be expected, Japanese banks hold the leading position in claims on China (Chart 4i).

Charts 5a-5d show the same data rearranged by creditor country. The U.S. data, for example, show declines in claims for every country, including China. The reductions in Poland and Yugoslavia were achieved though write-offs and sales of debt at a discount. The other declines represent a net repayment of principal.

Decisions by U.S. banks to reduce exposures were taken in response to deteriorating credit conditions, slim profit margins and limited U.S. trade with the countries in the area. These decisions were further influenced by the generally high exposure of U.S. banks to problem LDC credits in Latin America. Given their relatively large LDC exposures and pressure on their capital bases, the U.S. banks could not justify to maintain long-term lending to the East at the interest rate margins prevailing in the market.

This pull-back from international lending was also part of an overall reorientation in strategies by U.S. banks which found some focusing on domestic banking opportunities and others on international underwriting instead of long-term foreign lending. As as rule, the declines in exposure to the USSR and China were motivated primarily by the low profitability of such lending, while declines in other countries were more a response to U.S. banks' perceptions of worsening creditworthiness.

The activities of German and Japanese banks reflect many parallels -- sharp increases in lending to the USSR, China, Hungary and the GDR; significant, though less marked, increases in loans to Bulgaria and Czechoslovakia. The increase in German bank lending to Poland was due primarily to swaps of their Latin loans for Polish claims in the secondary market -- many German banks felt more comfortable with Polish risk than with Latin risk.

The strategies of U.K. banks represent an amalgam of the above strategies--sharp declines in claims on the GDR, Hungary and Czechoslovakia, but increases in the USSR and China. The declines shown for Poland and Yugoslavia primarily reflect the net reduction of exposure as a result of reserves mandated by the Bank of England.

The major puzzle that emerges from these data is the sharp divergence in lending strategies among German and Japanese banks on the one hand and U.S. and (to a lesser extent) U.K. banks on the other. One possible explanation lies in the pattern of trade flows to the East. Table 3 shows aggregate exports to the East and commercial bank claims on the part of the major western countries.

West Germany holds a commanding lead in total exports, thus providing a plausible explanation for the prominent position of German banks in financing these countries (though the export share far exceeds the share in claims). The relative size of Japanese bank claims exceeds the country's share in total exports and if rough estimates of short-term loans are included, Japan's share of total bank debt rises to about 32 percent (compared with an export share of 21 percent). Factors other than the size of export flows are clearly significant in explaining Japanese bank lending. More striking, perhaps, are the large relative shares of French and U.K. banks in total bank claims. Banks in all three countries appear to view the Eastern market as a safe region for the expansion of financial credits.

TABLE 3

WESTERN COUNTRIES' EXPORTS TO AND COMMERCIAL BANK CLAIMS ON EASTERN EUROPE AND CHINA

1988 — $ Millions

	EXPORTS	% OF TOTAL EXPORTS	CLAIMS	% OF TOTAL CLAIMS
WEST GERMANY	21583	34%	21709	25%
JAPAN	13513	21%	20336	24%
U.S.	9217	15%	3726	4%
ITALY	6491	10%	7360	9%
FRANCE	4855	8%	16114	19%
U.K.	3230	5%	9736	11%
SWITZERLAND	2426	4%	4640	5%
NETHERLANDS	2042	3%	2760	3%
TOTAL	63357	100%	86381	100%
INDUSTRIAL COUNTRIES	77557			

Source: IMF: Direction of Trade Statistics (1989), bank debt (see text).

III. New Direction in Private and Public Financing

Commercial Bank Strategies in Flux

Two factors will play significant roles in influencing future bank strategies in lending to the East: 1) the perception of worsening credit risk due to political upheavals in the area, and 2) an increasingly active role of western governments in trade and financial relations with the East. There are many common elements in the current environment that faces banks in Eastern Europe, thus a general discussion of such issues is relevant. It should be kept in mind, though, that banks will modify their strategies taking into account country-by-country differences and that any of the points made below may apply to a greater or lesser degree in any given country.

There is little doubt that in the past many banks viewed the lack of political change in Eastern Europe and China as a positive factor in creditworthiness. Most communist governments placed a high priority on servicing foreign debt and they were prepared to act to ensure prompt servicing of external obligations. But, as rapid and far-reaching political changes got underway in many countries, most banks reacted by reducing country risk ratings for countries in the area and by taking a wait-and-see posture.

Whether banks continue to sit on the sidelines or not will be determined by the success western governments have in implementing their new initiatives. If banks perceive that essential structural changes are in fact being introduced in given countries, they will most probably act to extend and deepen their financial involvement. Such activity would, thus, provide further support to the political goals western governments are seeking to translate into reality. On the other hand, there is also a risk that banks may use the opportunity that comes with an increased public role in financing to reduce their own exposure. This would be the case if banks see western aid being used by the recipient country to postpone genuine reforms and the inevitable internal sacrifices. The obvious outcome would be a substitution of public loans for private bank exposure, leaving the country no better off than before.

These considerations underscore the critical role conditionality must play in the new assistance programs under development. The heart of the problem lies in a basic conflict between the dynamics of political change and the requirements of systemic economic change. Even though political structures have changed radically in many countries, the economic systems remain largely unchanged, unreformed and, if anything, more inefficient -- given the current disorder -- than under the previous political regimes.

While the political system is moving to greater pluralism, economic reform requires a coalescing around a central reform strategy. But there is not even a clear vision anywhere of how to change the economic system in a way that is compatible with current political realities which demand quick results. Coherent programs with timetables and priorities setting out the key changes necessary to transform socialist economies into market-oriented, private systems are so far lacking. And past reform failures in Hungary and Yugoslavia, for example, give scant cause for optimism, since a successful transition model is still missing.

A related concern on the part of many banks is the still reluctant attitude in the East to embrace the western capitalistic model. One hears frequent discussion of the "third way," a sort of half-way house between capitalism and socialism. Banks view such talk as hopelessly naive, believing that a radical opening to foreign investment and rapid privatization is only way these countries will be able to "get over the hump" toward a private, market-oriented economic system. But preliminary feedback from Hungary and Poland, for example, indicates that political debates have served to enhance a latent strain of nationalism. Although foreign investment is still sought and welcomed, there are undertones that give potential investors reason to pause, as in the promises not to sell out the country to foreigners.

Private banks are not prepared to support any given list of reform objectives just because new political leaders in Eastern Europe are seen as serious or deserving in the eyes of western public opinion. The banks will support countries that privatize and restructure state enterprises, countries that open to free markets by changing antiquated property laws, but they will not put their money at risk in countries that merely talk about these goals without acting on them.

The banks' emphasis on structural reforms derives from their realization that greater involvement of their domestic clients in East European economies requires such changes. Improved fiscal and monetary policies and reduced trade deficits are all desirable and necessary, because there is little hope of implementing far - reaching reforms without them. But stabilization policies are not enough. Without structural reforms, western direct investment in the East will amount to dribs and drabs, rather than the infusion that can catalyze an economic turnaround. The challenge is to design programs that integrate traditional stabilization efforts with system economic reforms.

The list of structural problems is a long one:

1) the absence of laws defining private property rights of potential foreign or domestic investors
2) inadequate accounting systems and standards, which make valuation assessments problematic
3) inefficient and irrational tax systems
4) the absence of a properly functioning capital market and banking system, which hinders the efficient internal allocation of investment resources
5) labor laws which hinder the operation of a domestic labor market
6) the lack of free, internal markets for industrial inputs which gives rise to monopolies in wholesale distribution

While recognizing that such a list of reform priorities cannot be resolved overnight, banks are still looking for Eastern European governments to develop coherent strategies for dealing with these issues. Lacking such strategies, many banks will respond by cutting loan outstandings.

The implications of the above for public policy are several. Unless public policies toward Eastern European countries embrace these same goals for structural reform and back them up with concrete policies, we will find the public and private sectors acting at cross purposes--public money will simply go to bail out private loans and the hoped for inflow of western investment will fizzle. If the banks pull out their loans, western governments are unlikely to step up their capital infusions to make up the shortfall. This suggests that in order to meet their longer-term goals western governments should seek to create conditions under which private western capital will prosper and thrive, even if this causes eastern policy makers some discomfort in the near-term.

Secondly, western governments should realize that they have little knowledge of how such structural reforms might best be implemented, nor do they have the skills needed in the process. The IMF and the World Bank may clearly play a vital role in this regard, but they must be pushed in this direction and told to broaden and deepen their policy advice to Eastern European policy makers. Governments may also find that banks and other private companies have much to contribute to the process of structural reform; strategies to evolve public-private partnerships for specific tasks could prove valuable, especially in the fields of business management, credit training, accounting and marketing.

Public Strategies for Assistance to East European Reforms

The forces that have acted to shape and spur efforts in the West to aid reform in Eastern Europe have undergone rapid change during 1989. The initial focus of western interest was on Poland, where a Solidarity-led government assumed power, and Hungary, where an agreement was reached to hold free elections for the first time since the war. As work on putting together assistance packages for Poland and Hungary progressed, political changes in the GDR, Czechoslovakia and Bulgaria brought new governments into office. And to top off the year, President Bush announced a significant liberalization in U.S. economic policies toward the Soviet Union during the Malta summit in early December.

Given the rapid evolution of events during 1989, it is difficult to do more than sketch the general trends in official policy at the present time; 1990 will undoubtedly bring new developments, particularly as regards the GDR, Czechoslovakia and Bulgaria.

The basic premise of western policy as it emerged during 1989 was that the European Community should be assigned the central role in coordinating and guiding western assistance to Poland and Hungary. This role would now seem to apply to future western assistance policies toward the GDR, Czechoslovakia and Bulgaria.

The major differences in these cases is the special relationship between the Federal Republic and the GDR and the fact that none of these countries is as bad off economically as either Poland or Hungary, and thus, not in immediate need of emergency aid packages (thought Bulgaria may not be far from needing one). It also appears that Yugoslavia, which has tended to be neglected in the rush of new initiatives, will be added to the list of countries eligible for EC support.

In agreeing to play a secondary role in such initiatives, the Bush administration broke with policies of previous administrations which sought to set out a distinctive U.S. stamp on East-West relations. One reason for this change is the fact that the United States today in not in a position -- given worries with budget deficits and rising foreign indebtedness -- to play a major role in funding new initiatives. The United States seems happy to put priority on IMF and World Bank lending. Such indirect involvement, though, reduces Washington's overall influence on the size and distribution of credit and aid flows one way or the other. A related implication is that the United States will see its influence on the conditions attached to such credits diminish.

It is also significant that the Japanese have supported these initiatives, following in the footsteps of the United States, while carefully calibrating its contribution to an "appropriate" level in comparison with other countries. Japan's $150 million contribution to the Polish stabilization package compares with $250 million from Germany, $200 million from the United States and $100 million from France and the United Kingdom and Italy [6]. Although European comment on Japan's actions noted that Eastern Europe is an area with which Japan has had little contact [7], the data presented earlier show that Japan is Hungary's largest creditor by far and the number two creditor after West Germany for Eastern Europe as a whole. Japan, thus, has a large financial stake (through the exposure of its private banks) in the resolution of these problems.

It is still too early to speculate on the content of initiatives that will be forthcoming in 1990 for the GDR, Czechoslovakia, Bulgaria and Yugoslavia. Since only Yugoslavia is a member of the IMF and World Bank, a logical first step would be to encourage rapid progress toward membership. Czechoslovakia has already begun the application process and could secure membership by mid-year; the other countries will need more time.

The assistance packages being assembled by the EC for Poland and Hungary include:

--for Poland, a $1 billion stabilization loan from 12 countries and other aid and grants from a larger group of 24 OECD countries

--for Hungary, an ECU 1 billion ($1.2 billion) loan from the EC.

Both packages are conditional on each country agreeing to IMF standby programs. In addition, many countries have offered substantial official export credit lines. Germany, for example, has offered Poland $1.6 billion in trade credits, Italy has offered $400 million, France some $600 million and other countries will likely follow. German Federal and State guarantees for exports to Hungary have been hiked some $525 million and additional commitments are being made by the United States and other countries. In addition to new credits, Germany is writing off a substantial portion of past official credits to Poland and a part is being converted into zloties to be used for Polish-German projects in Poland [8].

With some $8 billion apparently committed or under discussion for Poland and Hungary [9], the obvious question is how these vast sums are to be used. EC thinking on this critical issue is not entirely clear but seems to focus on three elements:

1) piggy-backing new loans on IMF standby programs, thus introducing a form of cross conditionality (something which has been anathema for LDC borrowers in recent years)
2) encouraging the European Investment Bank and the World Bank to expand project financing in Eastern Europe
3) setting up a multilateral development bank, the Bank for Europe, along the lines of the Asian, African and Inter-American Development Banks, whose owners include both developed countries and the recipient countries from the relevant region [10]

Can such an approach work, given the forces at play in the region which will constrain and shape how East European policy makers act in the future? Unfortunately, the past record does not suggest that western politicians are very skilled in using aid flows to secure needed economic reforms.

The record shows, for example, that western governments bear a major responsibility for the uncontrolled expansion of Polish indebtedness in the period prior to the debt default in 1981. After banks restricted financing beginning in 1979, western governments offered loans with the goal of helping the "reform" efforts of Edward Gierek survive. There was little or no consideration of Poland's ability to use these funds within the country. When the credit squeeze became critical in 1980, both France and Germany made special deals with Poland in violation of long-standing agreements with other countries about export credits [11].

The improvement this time around is that western aid and credits are being tied to IMF and World Bank conditionality. But the Fund's record in Eastern Europe has been less than stellar. Despite a succession of Fund standby's in Hungary and Yugoslavia since the early 1980's, economic performance in each country has deteriorated steadily during the intervening years. The Bank's involvement has likewise been disappointing, especially in the field of structural adjustment lending. Two adjustment loans to Yugoslavia in the mid-1980's were complete failures. The lasting imprint of the Fund and the Bank on economic policy and structural change is difficult to discern today in either Hungary or Yugoslavia.

The point is not to jettison Fund and Bank conditionality, but to improve on it. Western governments need to push the Fund and Bank into designing structural policies to facilitate the hoped-for transition to a market economy. And new thinking is needed on structural issues that go beyond the contributions that the Fund and the Bank can usefully make. The proposed multilateral Bank for Europe, for example, could have a substantial impact in the field of structural policies, provided its creators avoid setting up the vast bureaucracies that characterize the other regional development banks.

A more radical proposal, especially for the U.S. government, would be for the governments to spend their aid money on buying advice for East European reformers from their own private companies. Governments might form partnerships with private firms by creating mixed public/private working groups to tackle specific priority problems in given countries, e.g. accounting and tax systems, property law, banking practices, business management, marketing, etc. Such initiatives are best organized on a bilateral basis.

Unless western politicians want to keep pumping public money into the East for the indefinite future, they must seek to create conditions in Eastern Europe under which foreign capital will thrive and prosper. The best way to find out what those conditions are is by working with the capitalists themselves. This is why western governments need to go beyond IMF and World Bank involvement. As vital as their role may be, neither the Fund or the Bank is comfortable in a close working arrangement with private companies. A second reason for seeking closer cooperation with private firms is to minimize the risk that public and private lending strategies work at cross purposes, with public monies bailing out private banks.

IV. Conclusions and Policy Recommendations

It is time to return to the question posed earlier: How can the West use its economic resources to best advantage in promoting the growth of political pluralism and a transition to free markets?

The first rule is for western governments to create a balance between public and private initiatives with regard to Eastern countries. Balance is important to insure that public and private institutions move in the same direction and are mutually reinforcing. More importantly, though, balance is essential to infuse market-based, private-sector conditionality into the process of resource transfer to the East. This is because the acid test of structural reforms will take place in the market place, not in some academic think tank or government office.

The second rule is for western governments to strike a balance between initiatives that involve monetary transfers and those that transfer skills necessary to survive and prosper in the market place. Money is needed, but if countries in the East do not acquire a-wide range of private business skills quickly, the reforms will falter and the money will have been wasted. Governments can and should help accelerate the transfer of western skills in the area of accounting, taxation systems, banking, marketing and business management. The best way to do this is by encouraging Rule #1's balance between public and private initiatives.

The third rule is for western governments to seek a balance between multilateral and bilateral initiatives. The multilateral role to be played by the IMF and World Bank should be broadened and deepened to encompass key structural reforms. But governments should go beyond this with bilateral initiatives. Such bilateral initiatives would include the transfer of those skills noted in Rule #2 above, but they should also focus on each country's special interests or talents in other areas, e.g. introducing business school courses or executive training programs, teaching English, organizing student and young professional exchanges, helping with the reorganization of public institutions such as central banks, statistical bureaus, stock exchanges, security and exchange commissions, etc.

There is a danger, though, if bilateral or EC initiatives lead to preferential conditions for western capital from certain countries in the East and for eastern exports in the EC. U.S. and Japanese firms would be disadvantaged, for example, by any terms of a special trade relationship that might be granted to Eastern European exporters to the EC. The United States and Japan each have stake in pushing for further market opening measures in EC on a non-preferential basis. Since many of the protectionist pressures are specifically directed against Japanese companies and given the already significant exposure of Japanese banks in the region, Japan faces important challenges in developing its Eastern European policies.

There are two final considerations for national security policy in the United States. One is that there are promising opportunities for new policy innovations to return the United States to forefront of East-West policy formation and implementation. The way to do this is by focusing on the transfer of those skills outlined above in Rules #2 and #3. The place to start, though, is with Rule #1--by creating a cooperative working relationship with the U.S. private sector on these issues.

A second is that U.S. policy must recognize that political changes in Eastern Europe are diverting attention away from Latin America and its problems. The expansion of EC initiatives toward the East in the context of continued U.S. inaction toward Latin America will serve to weaken U.S. authority and leadership both in Europe and in Latin America. Now that Secretary Brady's debt initiative has all but killed prospects of new commercial bank lending to many Latin nations, new thinking is required about how the resources necessary for the survival of these struggling democracies can be made available.

Footnotes

1. David Buchan, "Grouping for a New Strategy," **Financial Times**, December 8, 1989, p. 19. Delors ordered an office to be set up immediately.

2. "EC to Lend Hungary ECU 1 Billion Over Five Years," **Financial Times**, December 7, 1989, P. 3. The conditions were that Hungary agree to an IMF Standby, implement microeconomic conditions to encourage private enterprise, and that the loan should not by used to replace private credits.

3. Peter Truell, "Concern Mounts Over Tied Credit in Eastern Europe," **Wall Street Journal**, December 8, 1989, p. A5.

4. Compilations of these data are available from several sources: "Who is Financing the East Bloc: Sources of Commercial Bank Funds Loaned to Eastern Europe and the Soviet Union," **PlanEcon Report**, August 11, 1989; "Quarterly Review of Financial Flows to Developing Countries," an internal publication of the Debt and International Finance Division of the World Bank.

5. In the United States, banks report exposure net of specific write-offs, even though they still retain the full legal claim. Where such write-offs have been extensive, primarily Poland, the reported claims understate the remaining legal claims. It is unknown what reporting conventions are followed in other countries, but it appears that banks in Germany and Japan report legal claims without regard to write-offs taken or existing reserves, while U.K. banks reports claims net of specific reserves.

6. "Japanese Offer $150 Million for Polish Aid Fund," Financial Times, November 25, 1989, p. 3; "Japanese Tiptoe into East Europe," **Financial Times**, December 5, 1989, p.3.

7. Ibid.

8. Details of the arrangements mentioned in this paragraph may be found in the articles cited in footnotes 1, 2, 3, 6 and in: "U.S., West Germany Join Forces to Help Reformists in East Bloc," **Wall Street Journal**, October 20, 1989, p. 9.

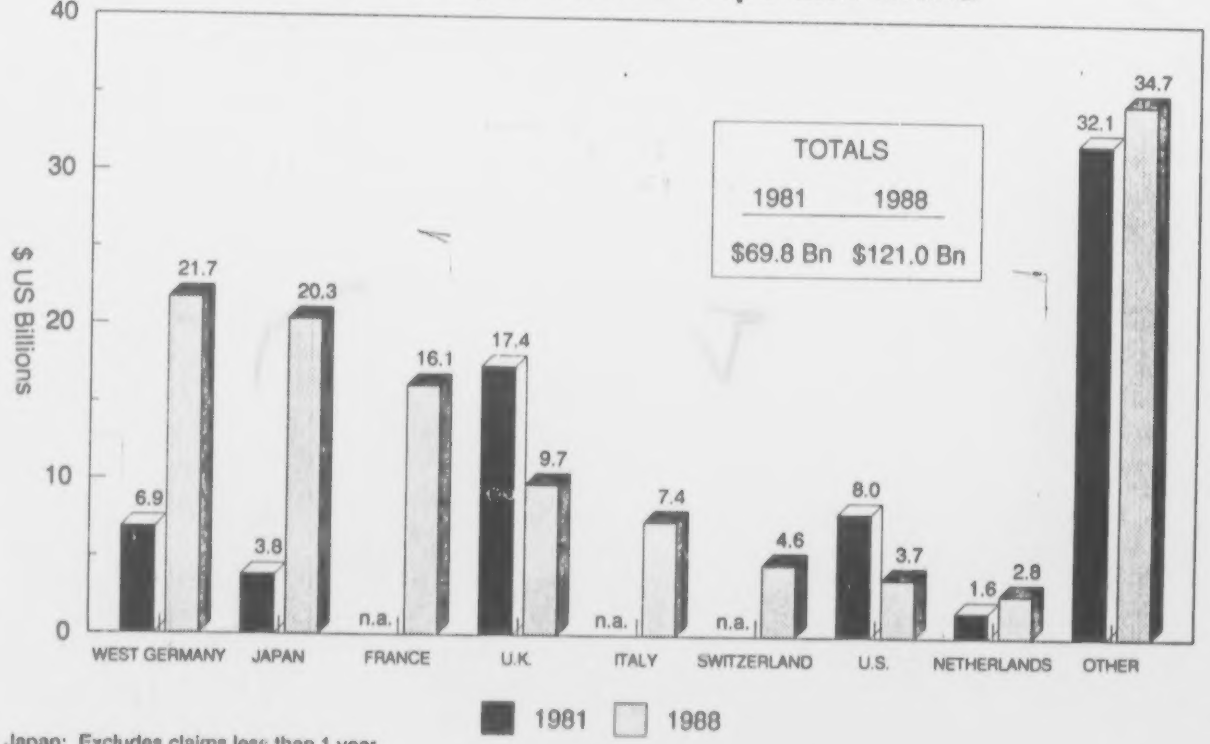
9. See footnote 1.

10. "EC Agrees to Set Up East Europe Development Bank," Reuters, December 8, 1989.

11. Lawrence J. Brainard, "Poland's Foreign Debt Crisis--Background and Perspectives," submitted as testimony to the European Subcommittee of the Senate Foreign Relations Committee, January 27, 1982, pp. 7-10.

CHART 1

Total Western Commercial Lending to the Soviet Union, Eastern Europe and China



Japan: Excludes claims less than 1 year.
: End-March 1981 and 1988.

CHART 2

Commercial Lending by Four Major Western Nations to the Soviet Union, Eastern Europe and China

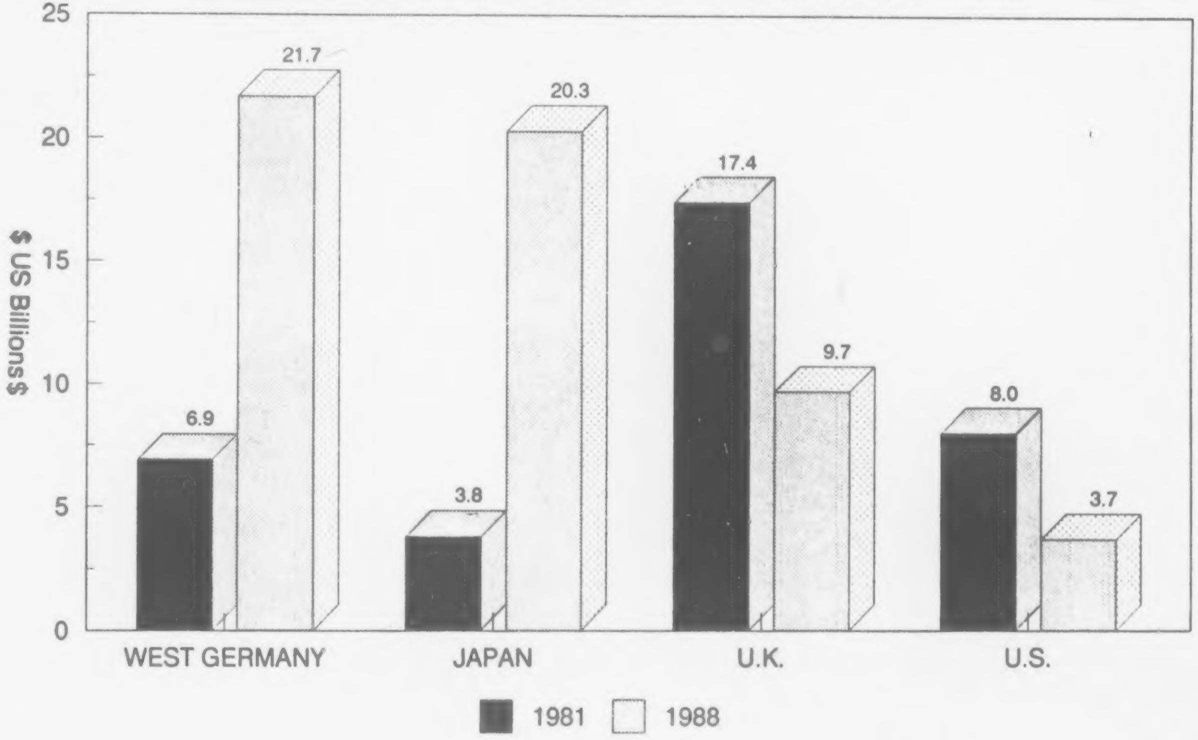
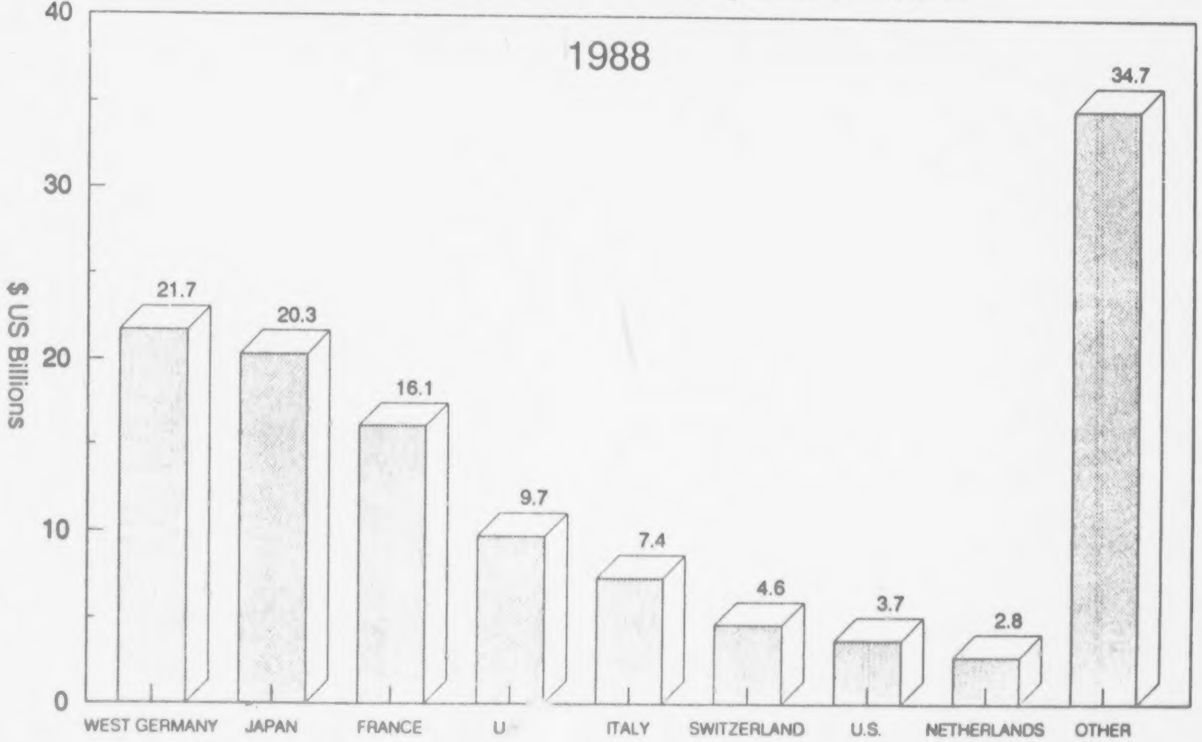


CHART 3
Total Western Commercial Lending to the Soviet Union, Eastern Europe and China



Major Creditor Nations in Commercial Bank Lending to Individual Countries

(Dec. 1981 vs. Dec. 1988)

Chart 4a	Soviet Union
Chart 4b	Bulgaria
Chart 4c	Czechoslovakia
Chart 4d	GDR
Chart 4e	Hungary
Chart 4f	Poland
Chart 4g	Romania
Chart 4h	Yugoslavia
Chart 4i	China

CHART 4a
Soviet Union

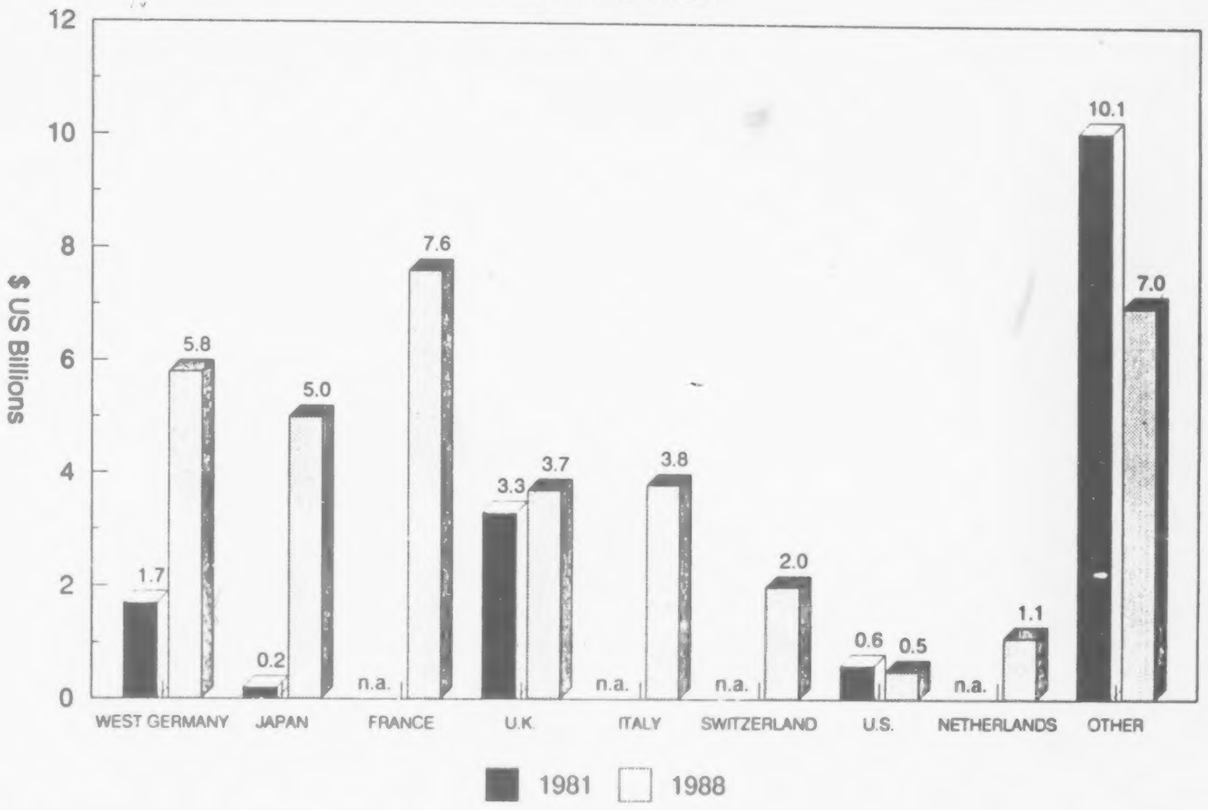


CHART 4b
Bulgaria

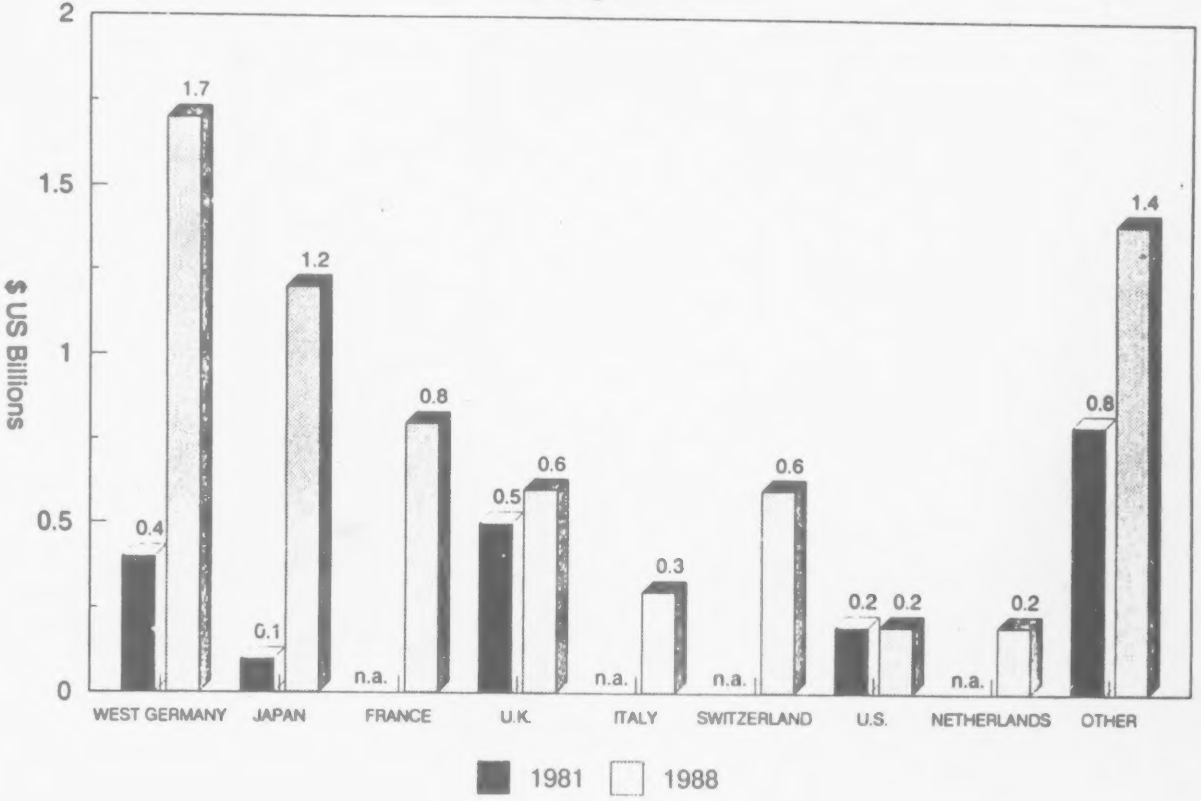


CHART 4c
Czechoslovakia

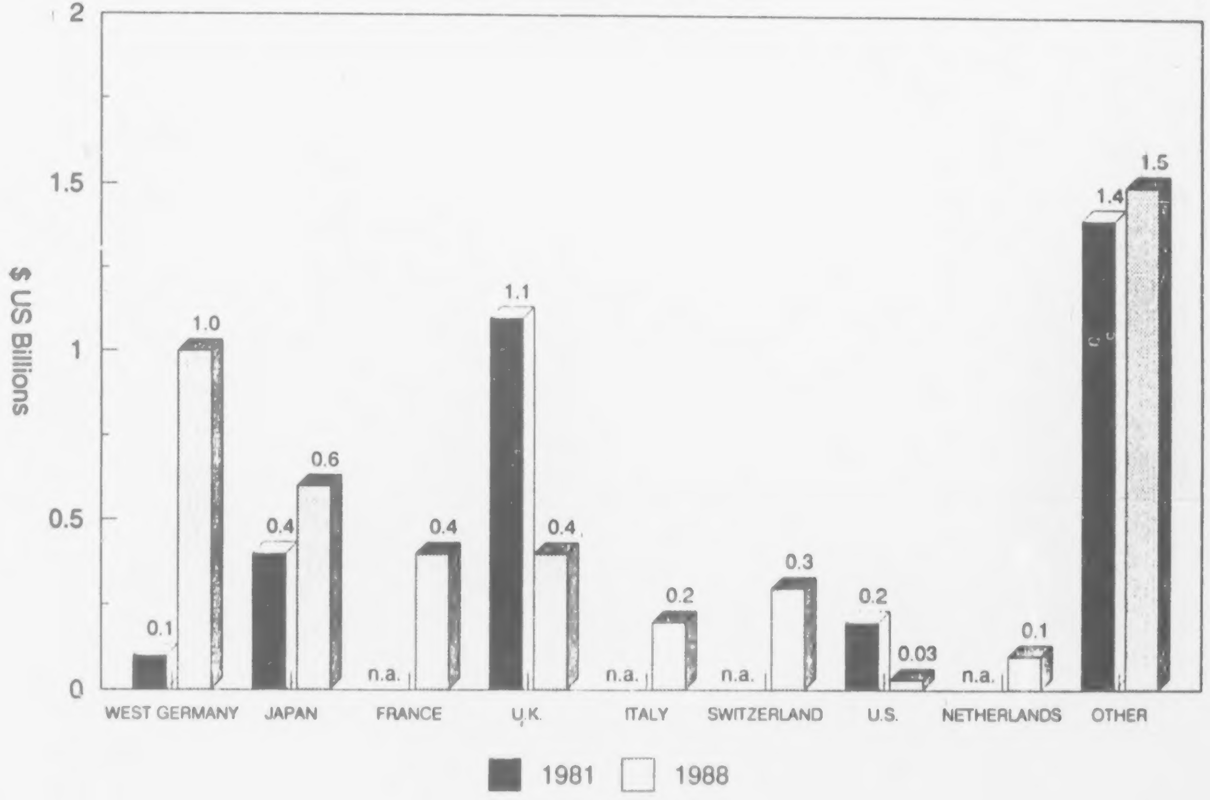


CHART 4d
GDR

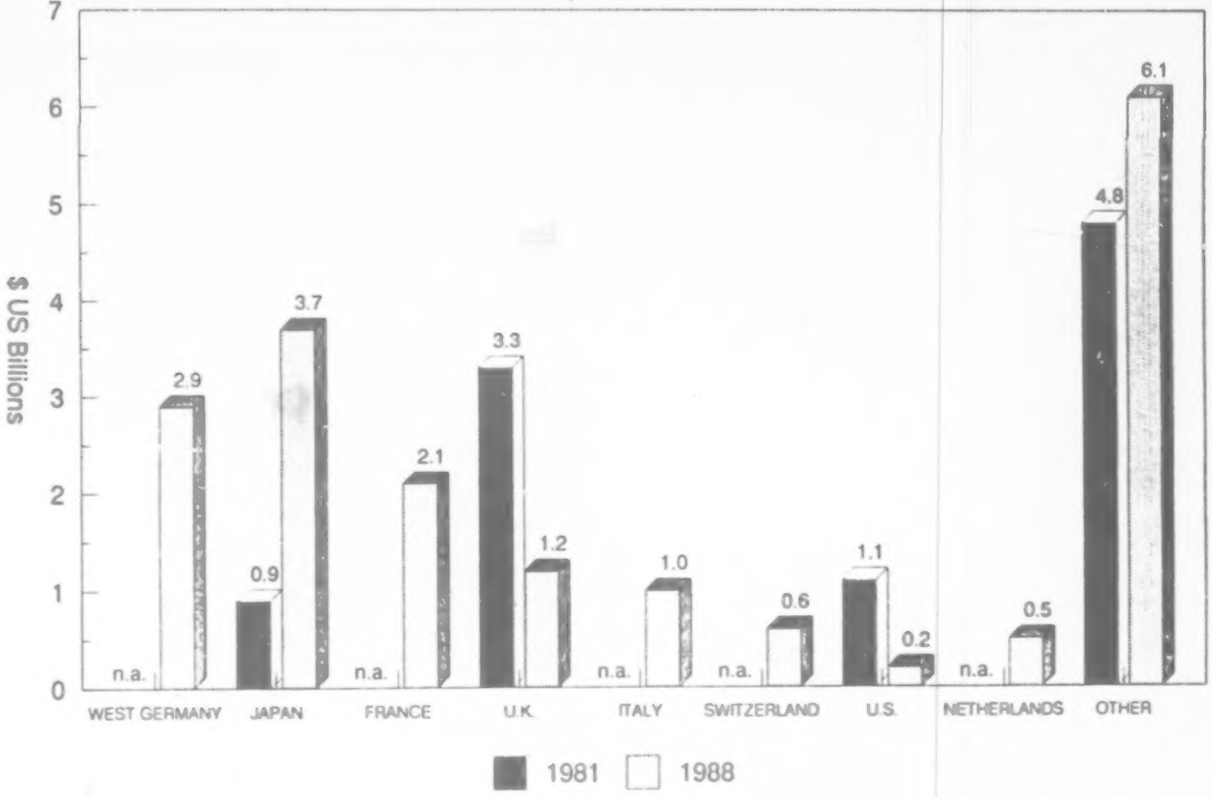

7
6
5
4
3
2
1
0
$ US Billions
n.a.
2.9
0.9
3.7
n.a.
2.1
3.3
1.2
n.a.
1.0
n.a.
0.6
1.1
0.2
n.a.
0.5
4.8
6.1
WEST GERMANY
JAPAN
FRANCE
U.K.
ITALY
SWITZERLAND
U.S.
NETHERLANDS
OTHER
1981
1988

CHART 4e
Hungary

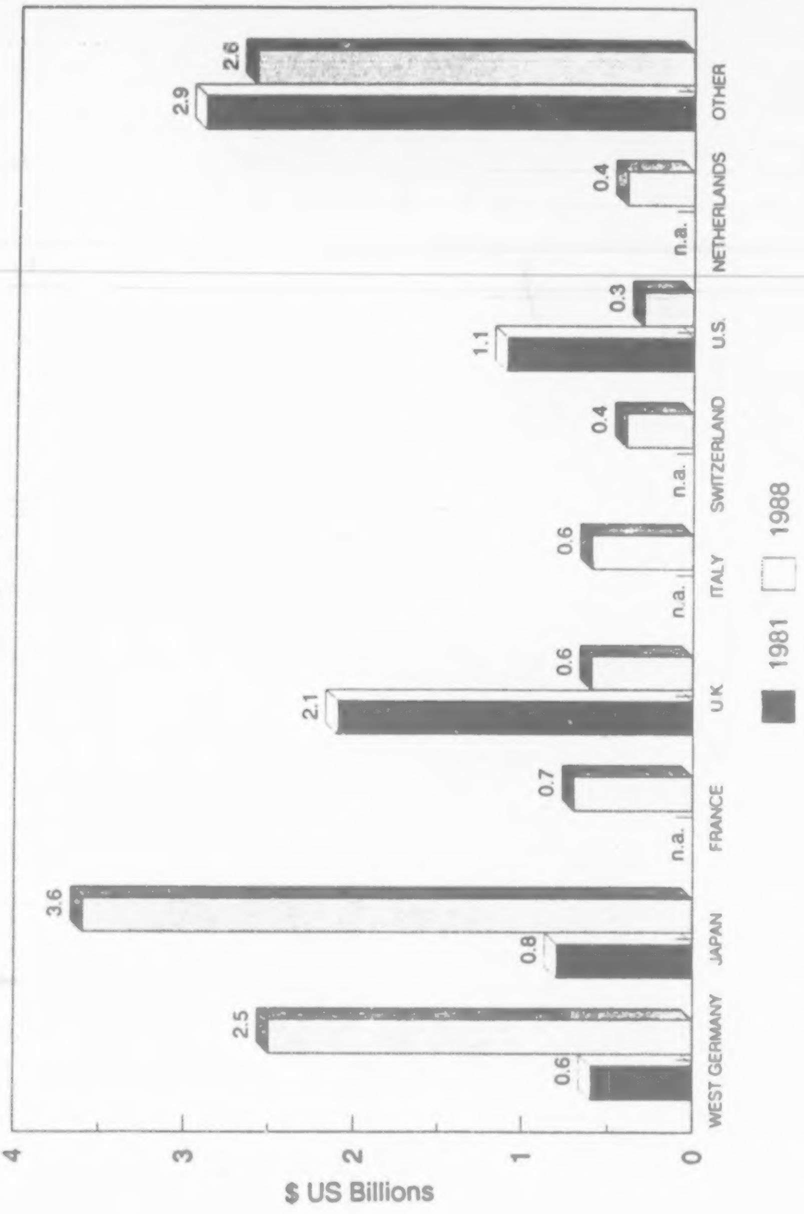


CHART 4f
Poland

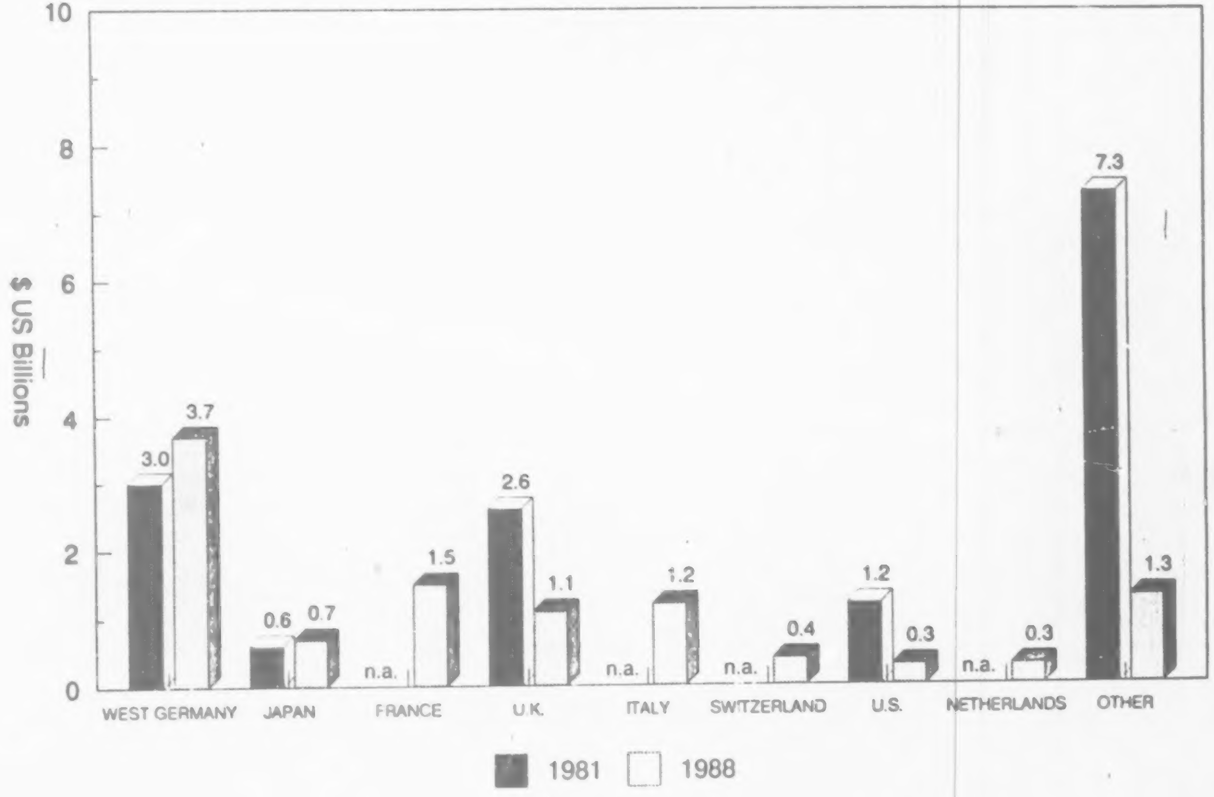


CHART 4g
Romania

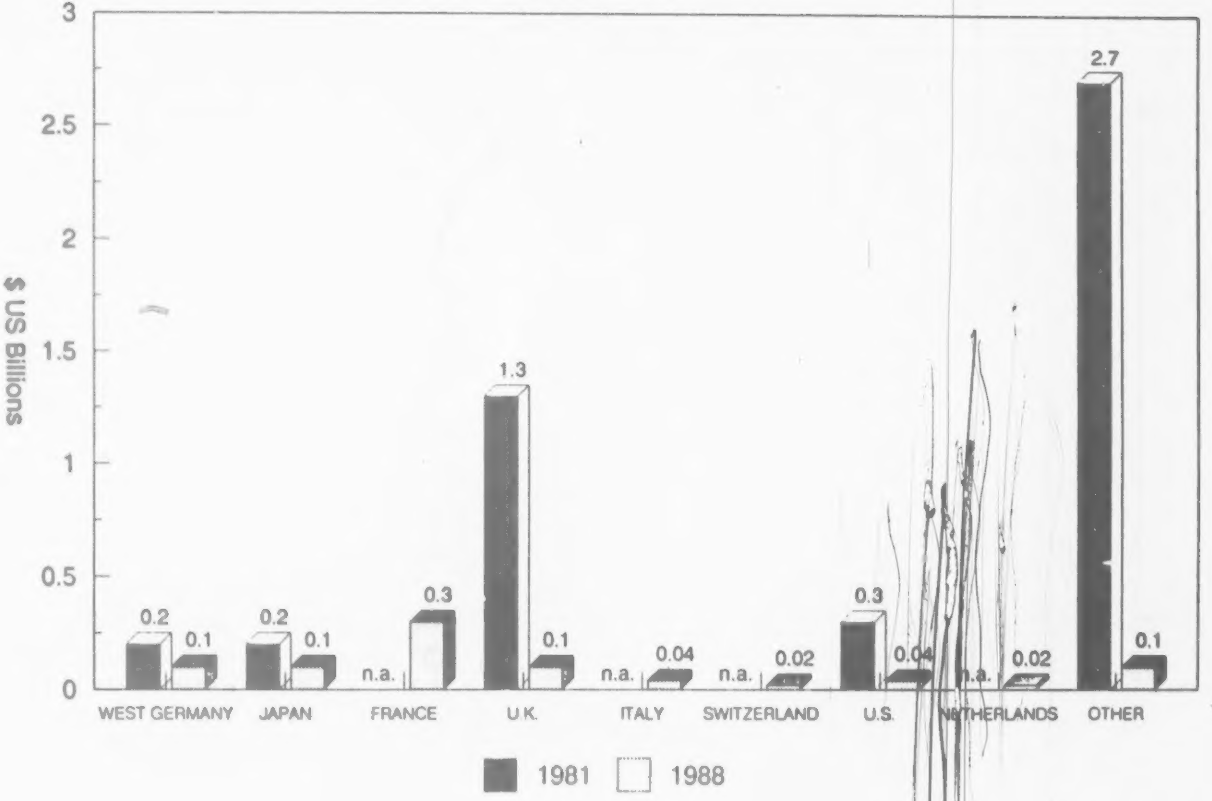
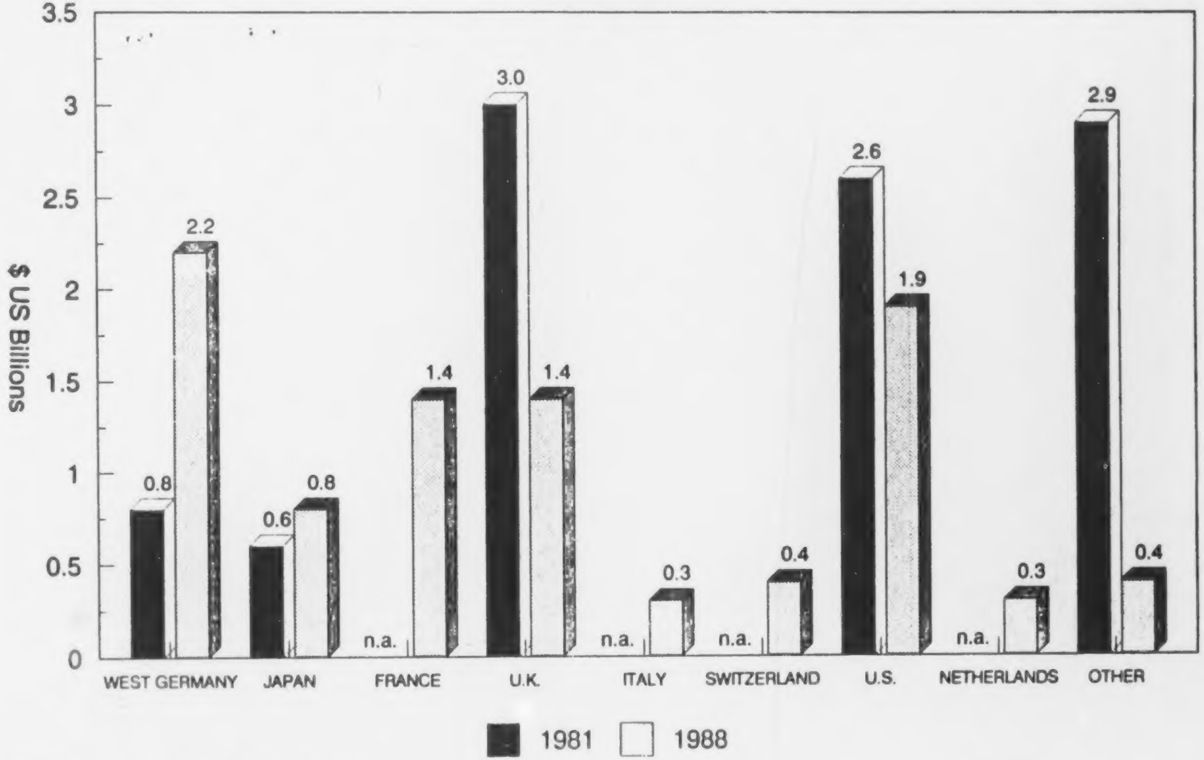
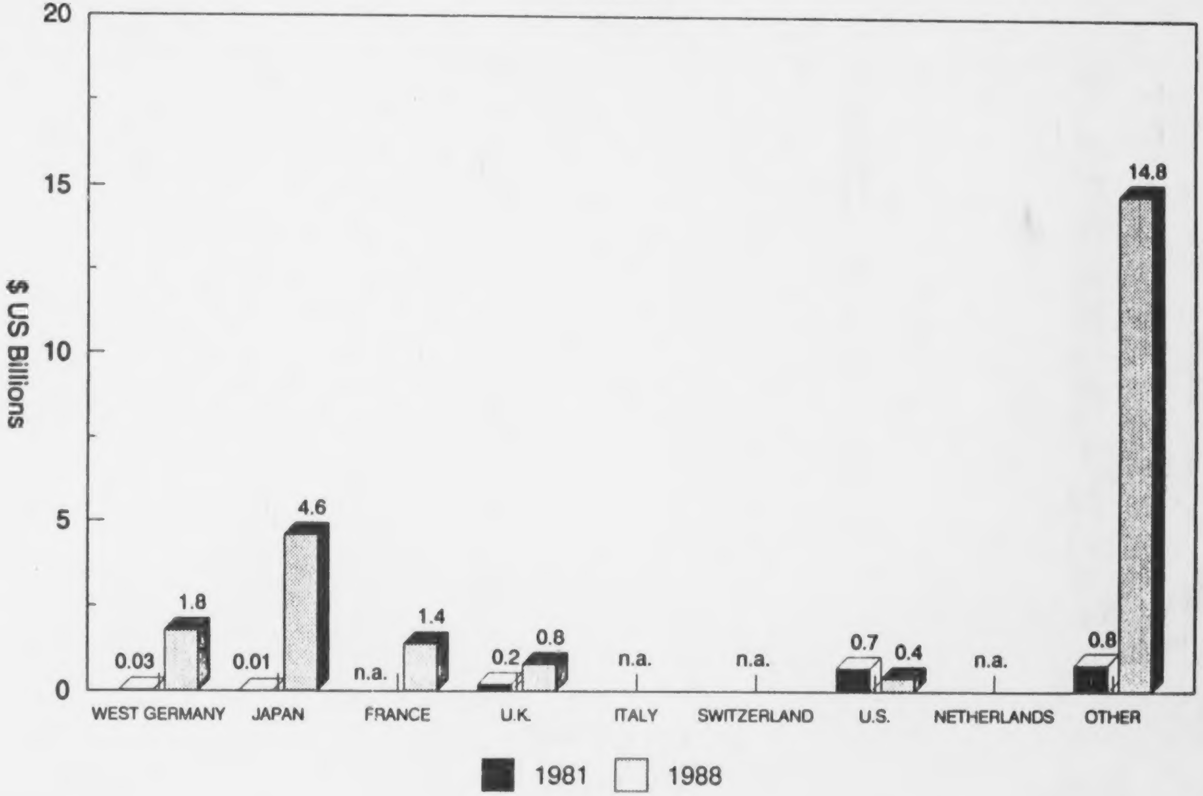


CHART 4h
Yugoslavia



West Germany "1981" is 1982 estimate.

CHART 4i
China



Commercial Loan Portfolio of Each Major Creditor Nation

(Dec. 1981 vs. Dec. 1988)

Chart 5a	West Germany
Chart 5b	Japan
Chart 5c	United Kingdom
Chart 5d	United States

CHART 5a
West Germany

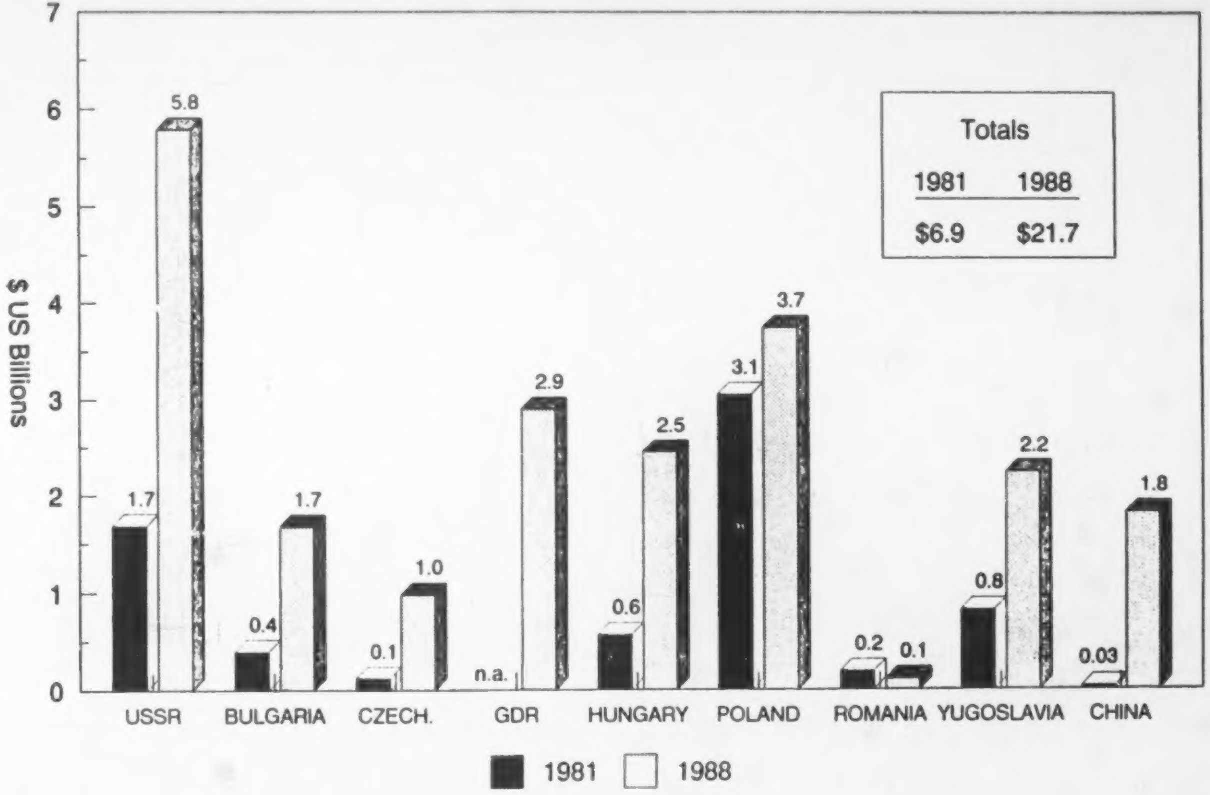


CHART 5b
Japan

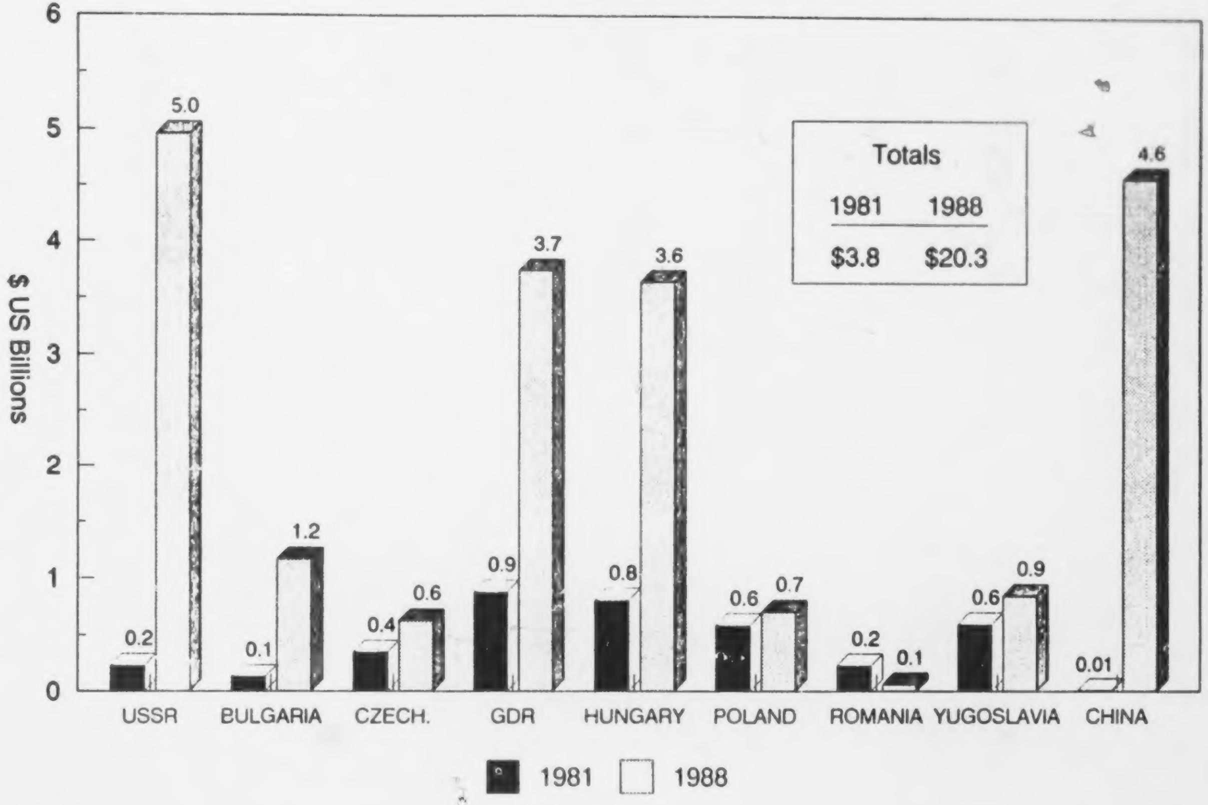


CHART 5c
United Kingdom

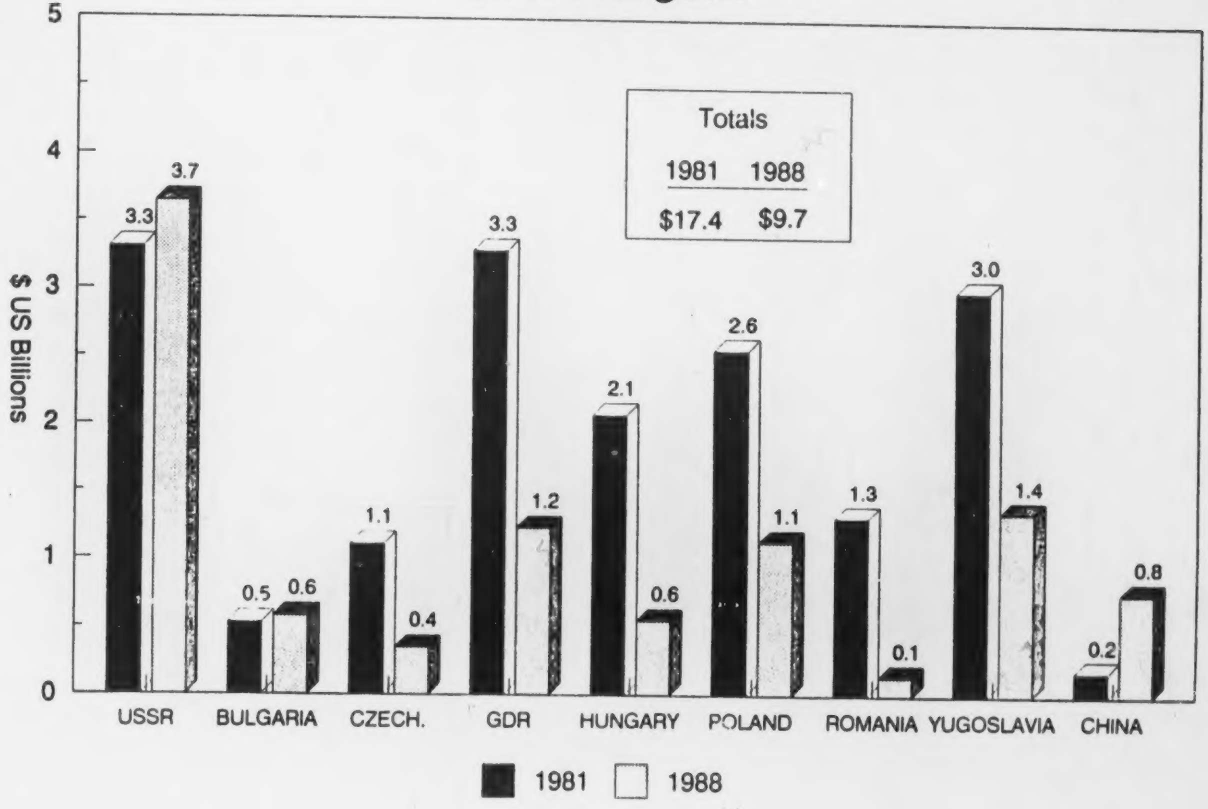
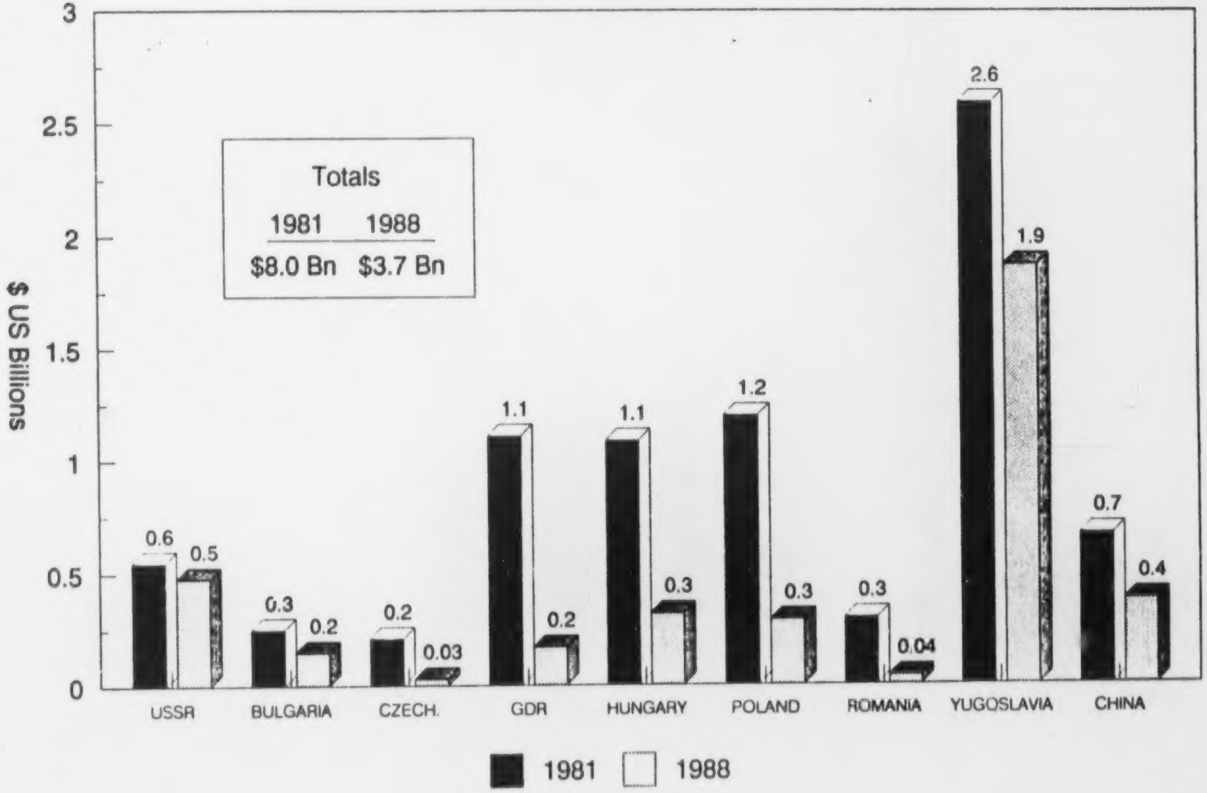


CHART 5d
United States



APPENDIX

BREAKDOWN OF COMMERCIAL BANK DEBT TO USSR, EASTERN EUROPE AND CHINA

	USSR		BULGARIA		CZECH.		GDR		HUNGARY	
	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
WEST GERMANY/(3)	1.7	5.8	0.4	1.7	0.1	1.0	n.a.	2.9	0.6	2.5
JAPAN/(1)/(2)	0.2	5.0	0.1	1.2	0.4	0.6	0.9	3.7	0.8	3.6
FRANCE	n.a.	7.6	n.a.	0.8	n.a.	0.4	n.a.	2.1	n.a.	0.7
U.K.	3.3	3.7	0.5	0.6	1.1	0.4	3.3	1.2	2.1	0.6
ITALY	n.a.	3.8	n.a.	0.3	n.a.	0.2	n.a.	1.0	n.a.	0.6
SWITZERLAND	n.a.	2.0	n.a.	0.6	n.a.	0.3	n.a.	0.6	n.a.	0.4
U.S.	0.6	0.5	0.2	0.2	0.2	0.03	1.1	0.2	1.1	0.3
NETHERLANDS	n.a.	1.1	n.a.	0.2	n.a.	0.1	n.a.	0.5	n.a.	0.4
OTHER	10.1	7.0	0.8	1.4	1.4	1.5	4.8	6.1	2.9	2.6
TOTAL	15.9	37.0	2.1	6.9	3.2	4.4	10.1	18.6	7.5	11.5

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(1) Excludes claims less than one year.
(2) End-March 1981 and 1988
(3) Yugoslavia 1981 is actually 1982 estimate

POLAND		ROMANIA		YUGOSLAVIA		CHINA		TOTAL	
1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
3.0	3.7	0.2	0.1	0.8	2.2	0.03	1.8	6.87	21.71
0.6	0.7	0.2	0.1	0.6	0.8	0.01	4.6	3.83	20.34
n.a.	1.5	n.a.	0.3	n.a.	1.4	n.a.	1.4	n.a.	16 11
2.6	1.1	1.3	0.1	3.0	1.4	0.2	0.8	17.37	9.74
n.a.	1.2	n.a.	n.a.	n.a.	0.3	n.a.	n.a.	n.a.	7.36
n.a.	0.4	n.a.	n.a.	n.a.	0.4	n.a.	n.a.	n.a.	4.64
1.2	0.3	0.3	0.04	2.6	1.9	0.7	0.4	7.96	3.73
n.a.	0.3	n.a.	0.02	n.a.	0.3	n.a.	n.a.	1.63	2.76
7.3	1.3	2.7	0.1	2.9	0.4	0.8	14.8	32.14	34.74
14.7	10.6	4.8	0.8	9.9	9.0	1.7	23.7	69.81	121.12

Sources:

1981:
West Germany, U.K.: World Bank
Except West Germany,Yugoslavia,1981: is actually 1982 estimate
Japan: JCIF
U.S.: Federal Financial Institutions Examination Council,
Statistical Release--June 3,1982
Total claims to Eastern Europe and China: PlanEcon, June 2, 1989

1988:
West Germany, Japan, France, U.K., Italy, Switzerland, U.S.,
Netherlands, Other: PlanEcon, August 11, 1989
China: World Bank, Financial Flows to Developing Countries; BIS

The Council for Mutual Economic Assistance: Rethinking the Past and Searching for the Future

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USA

I. The Nature of the CMEA

Like any other regional economic integration scheme, the Council for Mutual Economic Assistance (CMEA) is partly an economic organization and partly a political one. Regional economic integration schemes are economic in that they seek to generate increased trade among members and through these gains in inter-member trade to raise both the level and the growth of incomes of their members. They are political in that their formation requires an unusual degree of trust and cooperation among would-be members who face the prospect of yielding some sovereignty over their internal and particularly external affairs to the integration scheme. Moreover, in a number of cases, the move toward regional economic integration is spurred more by a reaction to the economic integration measures taken by other, competing or neighboring, countries than to economic logic thus raising the importance of political factors.[1] Finally, within each integration scheme, rules for operating the scheme and for the sharing of costs and benefits of integration require the existence of some political means for formulating and implementing policy decisions.

Assessments of the CMEA by western observers have been heavily influenced by this dual political and economic character of economic integration, and it is safe to say that the analysis of the CMEA has tended to stress the political aspects of socialist economic integration as the key to the understanding of the CMEA's structure and functioning. There are three reasons why the political nature of the CMEA has been stressed at the expense of economic factors. The first of these is the unique role of the Soviet Union in the integration scheme. While other integration schemes have a diversity in member size and political leverage, the role of the Soviet Union in the CMEA is so overwhelming as to make the CMEA unique among the world's integration schemes. Moreover, Soviet predominance is so multifaceted as to encompass virtually all aspects of relations among CMEA members. For many years the Soviet Union's ideological preeminence in formulating the objectives of socialism as well as the means of achieving them was unchallenged, and even when national roads to socialist development began to appear in the 1960s it was quite clear that the extent to which CMEA members could adopt such independent paths depended on tacit Soviet acquiescence. The Soviet Union also played a major role in the defense of CMEA, stationing troops in many CMEA member countries and generally carrying a higher share of the bloc's defense burden than did the smaller East European members. The political predominance of the USSR in CMEA has been matched by its economic preeminence. As Table 1 shows, the Soviet Union is the CMEA's largest member, in terms of both GNP and population, and is also the largest single trade partner for each of the East European members. Moreover, Eastern Europe is critically dependent on the Soviet Union for its supplies of energy and raw materials and as an outlet for industrial goods that would be difficult to sell in western markets.

The evolution of the CMEA as an institution also tends to support the hypothesis that politics rather than economics is the basis for the CMEA's structure and operation. The CMEA was founded in 1949, at the height of Stalin's political control over Eastern Europe and a period of Soviet economic exploitation of Eastern Europe.[2] Only under Khruschev, when the informal, Stalinist, means of control and exploitation began to be dismantled was it that CMEA institutions began to be strengthened, in large part on Soviet initiative. It is appealing to view the expansion of the CMEA's role as a replacement for the Stalinist methods of economic control and exploitation that were being dismantled and to suspect that the CMEA was merely a bureaucratic substitute for

Stalin's autocratic means of strengthening the Soviet economy at the expense of CMEA partners.

The final reason for stressing the political nature of the CMEA is that the CMEA mechanism for regional economic integration is not very transparent. In integration among market economies, the means by which trade among members is increased in relatively easy to understand. Tariffs and other barriers to inter-member trade are reduced, thus increasing trade and factor movements among members and leading to greater economic efficiency, higher incomes and faster growth of output. In trade among centrally planned economies the comparison of domestic and foreign prices is not the motive force behind trade flows. Thus there appears to exist no autonomous, purely economic, mechanism that could be used to promote intra-CMEA trade. Rather CMEA trade has been promoted by means of plan coordination among member countries, specialization agreements, complex programs and other bureaucratic measures. These measures have two common denominators. The first is that they are all political in the sense that their implementation cannot be brought about by autonomous economic forces but rather requires the conscious effort of authorities in each member country to comply with and implement CMEA agreements. This thus makes both the design and the implementation of CMEA integration an act of political will rather than the outcome of impersonal economic forces. The second common element of CMEA integration measures is that they have generally been regarded as ineffective and insubstantial by observers both within and outside CMEA.[3]

The combination of great opportunities for the exercise of political power by the Soviet Union in the design and operation of CMEA and a lack of objective economic mechanisms to act as a counterweight to such power constitutes to many observers strong prima facie evidence that the CMEA is an organization whose genesis and outcomes reflect primarily political rather than economic forces and that in this political process the Soviet Union and its interests are the dominant factors. This view of CMEA has been supported by a number of studies claiming to provide evidence of the exploitation of the smaller CMEA members by the USSR or of the inequitable distribution of the gains from CMEA integration in a way that reflects Soviet political objectives.

To the extent that the CMEA has been viewed as an economic organization, meant to foster economic integration among like-minded countries with similar economic systems, the assessments of its success have been distinctly negative.[4] CMEA's economic shortcomings have been attributed to a number of factors. The members of CMEA are alleged to have economic endowments that differ excessively. As a result, integration leads to trade diversion, as CMEA importers of manufactures turn from low-cost developed economy producers to higher-cost CMEA suppliers. Moreover, a lack of similarity in endowments precludes opportunities for intra-industry trade and competition, thus limiting the opportunities for integration to promote competition and specialization.[5] These structural barriers to trade are augmented by the economic systems of the member countries and by the CMEA integration mechanism. The system of central planning vitiates the competition- and efficiency-stimulating effects of integration-induced trade in two ways. First, because prices do not influence input or output decisions, trade cannot displace inefficient domestic production nor direct resources toward efficient export industries. Second, planners tend to be trade averse and disinclined to depend on supplies from producers beyond their control, and enterprises tend to be vertically integrated in order to protect themselves from shortages in, and the poor quality of, input supplies. These tendencies limit the volume of trade and the ability to trade parts and components in addition to finished products. Distortions in pricing and inconvertibility of national currencies further constrict trade by forcing bilateral balancing of both aggregate trade as well as trade in various categories of hard and soft goods.[*] Finally, CMEA integration is limited to traditional commodity trade, particularly of finished products. There is no real movement of capital and of labor and particularly of technology and firm-specific knowledge among members.

The current political and economic reforms in Eastern Europe and the Soviet Union have forced a serious rethinking of CMEA, leading to questions regarding the viability of the organization as currently constituted. Among the centrifugal forces at work on CMEA members are the lure of western markets, the need for western capital and technology and the process of economic integration going on in Western Europe. Moreover, as the Soviet Union becomes less willing or interested in maintaining political control over Eastern Europe, there is an expectation that it will also become less interested in sustaining CMEA as an institution. Therefore, as the individual members of CMEA pursue economic reforms at differing speeds and in different directions, the ability of CMEA to provide a mechanism for integration may be reduced to the point where the organization will simply be unable to fulfill a useful role.

If the CMEA is perceived primarily a political creature of the USSR, providing few genuine benefits of integration to its members, then the relaxation of Soviet hegemony over Eastern Europe must surely lead to the demise, or at least atrophy, of the organization unless an economic rationale can be developed to replace political motivations. On the other hand, if the CMEA does, in fact, currently serve an economic end with some degree of success, then it is in the interests of its members to attempt to reform the CMEA in such a way as to retain and increase its ability to provide them with the benefits of integration.

To determine which of these positions more nearly reflects the realities of CMEA integration, this chapter examines the evidence on the political and economic determinants of CMEA integration. From this evidence I argue that CMEA integration did, in the past, fulfill a useful economic function for its members. This function was the provision of a regime for the conduct of foreign trade; a regime that was, of necessity, both unique and flawed due to the centrally planned economic systems of the participating countries. Thus, because the CMEA did fulfill an economic function for its members, it is reasonable to give serious consideration to the possibility that the CMEA could be reformed in such a way as to continue to provide a viable regime for trade among its members while overcoming past defects in CMEA integration and adapting itself to the reforms being undertaken by member countries.

II. The Evidence for a Political CMEA

If the CMEA were a creature of the Soviet Union, designed largely to achieve Soviet political and economic objectives at the expense of Eastern Europe, then the evidence must be sought in the distribution of economic and political gains between the USSR and the other CMEA members. The first attempt to provide such evidence was undertaken by Horst Mendershausen (1959, 1960) who examined Soviet foreign trade data for 1955-59 and discovered that the Soviet Union charged its East European partners prices 15 percent higher than those charged West European importers of the same goods. Similarly the Soviets were found to pay, on average, 15 percent less for importers of similar goods from East Europe than they paid West European exporters. Mendershausen interpreted this as evidence that the Soviet Union was able to exploit its East European partners by virtue of its large size and the monopoly and monopsony power derived therefrom.[7] In this interpretation, the political objective behind CMEA integration was the maximization of Soviet economic benefits at the expense of Eastern Europe.

This view was strongly challenged by Franklyn Holzman (1962, 1965) who examined not only Soviet trade with CMEA and the West but also the trade of other CMEA countries. He found that the Soviet pricing pattern uncovered by Mendershausen held true for these countries also. They, too, charged the USSR more for exports than they did western partners, and they paid less for Soviet imports than they paid for similar goods purchased in the West. Thus the Soviet Union no more exploited its CMEA trading partners through the CMEA pricing mechanism than did they exploit the USSR in the same way. The perception of exploitation resulted, according to Holzman, from two phenomena. The first was that the West discriminated against CMEA members.[8] Thus, in order to sell to the West, these countries had to discount their exports below the prices obtained within CMEA and they also had to pay more for imports from the West. Second, and more important to Holzman's view, was the fact that the CMEA should be viewed as a customers union, one that promotes trade among members not by lower tariffs but rather by means of administrative decisions. As a result of this administered integration, intra-bloc trade prices need not approach world market prices and the appearance, but not the reality, of exploitation is created.

A methodologically similar approach was employed by Marrese and Vanous (1983, 1988) to show that in the 1970s and 1980s, it was the Soviet Union that provided subsidies to or was, in effect, exploited by, its CMEA partners. The basis of the Marrese-Vanous estimates of the Soviet subsidy rests on well-known features of intra-CMEA prices. For most of the period under discussion, these prices were based on an average of past world market prices and were fixed at this level for several years at a time. As a result, systematic differences between contemporaneous intra-CMEA and world market prices evolved. In part these differences were due to the fact that in the 1970s the prices of fuels and raw materials increased rapidly. Consequently, world market prices for such commodities far outstripped the more slowly changing intra-CMEA prices. In part this was due to the fact that intra-CMEA prices were based on an average of past, and thus generally lower, prices and in part because they were not up dated frequently enough. At the same time, it was easy for CMEA exporters to sell such homogeneous commodities as oil and natural gas on western markets at the going, and much higher, world market price. Thus the opportunity cost of exporting such goods to CMEA partners was the difference between the high world market price that could be obtained by exporting to the West and the artificially low CMEA price. Exporters of machinery, equipment and consumer goods, on the other hand, benefited from the slow evolution of intra-CMEA prices because the world market prices of these goods increased more slowly than did those of fuels and raw materials creating less of a price gap for manufacturers than existed for fuels and raw materials. More important, most of the manufactured goods traded within the CMEA at world market prices were, in fact, not saleable on world markets at these prices, but rather had to be discounted in order to make them acceptable to western buyers. In effect, then, a country exporting fuels and raw materials to CMEA partners obtained lower prices than could be obtained on world markets, while if it imported manufactures from CMEA partners, it paid more for them than their value on and presumably, then, the cost of substituting for them from, the world market.

If the commodity composition of trade for all CMEA countries were roughly similar, such a distortion in prices would have no great implications. However, in intra-CMEA trade the Soviet Union is by far the largest, if not the only, net exporter of fuels and raw materials and net importer of manufactured goods. Thus the Soviet Union is exploited by Eastern Europe both because it sells its raw materials at prices that are below those available on world markets and because it pays world market prices for low quality East European manufacturers that could be replaced either with higher-quality western goods or with goods of East European quality purchased from the West at prices lower than those paid to East European exporters. Given the volume of Soviet-East European trade, its heavily raw materials for manufacturers structure, and the gap between world and CMEA prices, the exploitation of the Soviet Union was estimated by Marrese and Vanous to be in excess of $5 billion annually in the late 1970s.

This finding that the Soviet Union subsidizes Eastern Europe is paradoxical if one accepts Mendershausen's results or at least the implicit logic behind them, that the Soviet Union's political and economic power vis a vis its smaller and weaker CMEA partners should enable it to exploit them. Marrese and Vanous attempt to resolve this paradox by arguing that, rather than being exploited by its smaller and weaker CMEA partners, the Soviet Union had designed the CMEA and its pricing mechanism so as to disguise from its own citizens and from the citizens of the other CMEA members the fact that the Soviet Union is paying subsidies to the East European countries. The objective of these subsidies is to purchase from these countries a range of intangible geopolitical goods and services. Among these Marrese and Vanous include military security for the USSR provided by East Europe in the form of commitments to the Warsaw Pact, a geographic buffer between the USSR and Western Europe, support for the expansion of Soviet influence in the Third World, and political and ideological conformity with the USSR. The purchase of these "unconventional gains from trade" must be hidden from both the Soviet population, which would resent the subsidization of East Europeans at the expense of Soviet consumers' economic welfare, and from the East European populations, which would resent the loss of sovereignty implied by this sale of political loyalty and security services to the Soviet Union.

The proof for this view of the CMEA as a political creature designed to further covert Soviet aims is the distribution of these subsidies among CMEA members. Loyal countries bordering on the West, such as Czechoslovakia and the GDR, receive the largest subsidies on a per capita basis while less loyal and less strategically located CMEA members, such as Poland and Romania receive smaller subsidies. Thus, the more the Soviets pay, the greater the geopolitical benefits they receive.

This view of the CMEA as mechanism for distributing political payoffs among its members has been challenged on both technical and conceptual grounds. Among the technical critiques are those, such as Marer (1984), Pozanski (1988) and others, who argue that the discounts on East European manufacturers employed by Marrese and Vanous in their calculations are excessive, and that more realistic values would either sharply reduce the magnitude of Soviet subsidies to Eastern Europe or eliminate them altogether. While such critiques may well be correct, or at least certainly not less plausible from a methodological standpoint, there is nevertheless a strong perception among both economists and politicians within the CMEA that the phenomenon that Marrese and Vanous claim to quantify does, indeed, exist, and it is this perception more than any scholarly estimates that drives the geopolitical behavior of the countries involved.

This is not to say that the East Europeans or western observers agree that East Europeans' belief in the existence of these subsidies does, indeed, induce them to reciprocate with political and military benefits. Holzman (1987, Ch.

10), for example, argues that Soviet subsidies are a from of compensation to East Europe that makes up for the welfare losses these countries are made to bear by being forced to trade too much within the bloc and too little with the rest of the bloc. This view that East Europe suffers static losses from overtrading within the CMEA has a dynamic counterpart in the arguments of Kves (1983) and Marer (1984) who claim that East Europe's excessive reliance on the undemanding Soviet market has stifled the development of new, competitive products in East Europe and thus both reduced the pace of technological progress and economic growth in these countries and rendered their industries uncompetitive on world markets.

This view that the subsidies measured by Marrese and Vanous are a conscious or unconscious form of reparations for the economic damage done by the USSR to its partners has, in turn, been subject to criticism, Brada (1985, 1988). The argument for the existence of static losses rests on the impressionistic assumption that the CMEA countries overtrade with each other; in the following section evidence is presented which casts doubt on this belief. The argument for dynamic losses assumes that it is trade with the Soviet Union that leads to the low quality and lack of innovation that characterizes East European industrial output. The reality, however, is that these defects are the function of the economic system that exists in these countries. The defects cited in goods designed for export to the USSR or to other CMEA members are equally evident in goods destined for domestic consumption or for non-CMEA markets. This line of argumentation thus reduces to the claim that the Soviets are paying reparations for the damage wrought by the imposition of their economic and political system on the countries of Eastern Europe. Although "new thinking" in the Kremlin may well have led to this realization in recent years, it is most unlikely that the Soviet leadership of the 1960s and 1970s would have viewed the imposition of Soviet-style communism on Eastern Europe as anything other than a boon for which the Soviet Union ought to reap thanks rather than make amends.

A more fundamental critique of the conception of the CMEA as a predominantly political scheme focusses on weaknesses in the political economy of the Marrese and Vanous approach.[9] A key element of their hypothesis is that there is a close correlation between the benefits provided by each CMEA member to the USSR and the subsidies, either total or per capita, granted to each member. This correlation, depends, of course, on the ranking that one constructs of the benefits, and, given their intangible and non-quantifiable nature, such a ranking is of necessity impressionistic and subjected to different interpretations.

The furhter shortcoming is that way in which the subsidies are allocated is not clearly explained by Marrese and Vanous, though the explanation they do offer tends to change over time, presenting critics with something of a moving garget.[10] At times it is claimed that subsidies are the outcome of Soviet welfare maximization, at other times of a rather ill-specified bargaining process where Soviet behavior is rather naive and East European interests are articulated in a one-dimensional way that prevents any strategic behavior in negotiations over the supply of benefits to the USSR and that certainly does not link the economic demand of these countries for subsidies to a willingness to provide geopolitical benefits to the USSR.

Although Marrese and Vanous attribute to the USSR the ability to allocate subsidies to CMEA members with considerable precision by selecting the net volume of raw materials and fuels exports and manufactured good imports, the total volume of subsidies is hardly controllable. Indeed, total subsidies are divided into intended and unintended, the latter resulting from unanticipated movements in world market prices. However, the level of desired subsidies is strangely unrelated to political and economic forces that should influence Soviet demand for and ability to purchase geopolitical benefits from East Europe. Indeed, undesired subsidies tend to be greater than desired ones, a curious outcome in view of the precision in the allocation of subsidies among CMEA members, and total subsidies increase steadily in the 1970s, implying that Soviet demand for geopolitical benefits was unaffected either by detente or by increasing economic difficulties in the Soviet economy.[11]

Finally, the subsidy theory assumes rather than demonstrates that the payment of subsidies brings forth a supply of geopolitical benefits. Since the entire objective of CMEA pricing is to hide the subsidies from the populations of the recipient countries, it is then difficult to understand how the political attitudes and behavior of these populations is to be influenced.[12] If the populations are not the objects of the subsidies then the subsidies must be directed to the leadership of the CMEA countries, and here an analysis of their geopolitical interests that goes beyond subsidy maximization is needed but not provided.

Thus to view the CMEA solely as a political mechanism whose design and operation are geared primarily to the political and strategic objectives of the Soviet Union cannot be established solely on the purported existence of the kind of exploitation and subsidies found by Mendershausen and by Marrese and Vanous. As the foregoing discussion suggests, alternative and equally plausible explanations for the phenomena used to argue for Soviet political exploitation of CMEA exist. One useful piece of evidence to consider when choosing between a political and an economic perspective on CMEA would be to evaluate the CMEA's economic performance as an integration scheme. If CMEA was largely a political creature of the USSR, then its economic benefits ought to be minor; if, on the other hand, its economic benefits are significant, then it is possible that the CMEA is primarily an economic organization that provides useful trade benefits to members and thus an organization that can survive a major change in political relations between East Europe and the Soviet Union.

III. The Evidence for an Economic CMEA

The economic benefits of integration are the static benefits from an increased volume of inter-member trade, generally referred to as trade creation, and the dynamic benefits that integration brings through a more rapid growth of productive factors and of their productivity. Thus the economic basis for the CMEA's existence must be sought in a quantification of these effects and their comparison with the effects of other integration schemes that are generally accepted as having been successful.

A. Static Gains from Trade

Among the first efforts to measure the ability of the CMEA to increase trade among its members is that of Hewett (1976). Hewett estimated a so-called gravity equation, a general equilibrium model of bilateral trade among countries. The model posits that exports from country i to country j, X_{ij}, can be determined by

$$X_{ij} = AY_i^{\alpha_1}Y_j^{\alpha_2}N_i^{\alpha_3}N_j^{\alpha_4}D_{ij}^{\alpha_5}U_{ij} \qquad \text{Eq. 1}$$

where A is a constant; Y is the income, usually measured by GNP; N the population; D the distance between the two countries; and U_{ij} an error term. It is generally assumed that the parameters α_1 and α_2 are positive because countries with higher incomes will trade more and that α_3, α_4, will be negative because larger countries are more self-sufficient as will α_5 because distance is a barrier to international trade. The effects of a customs union are estimated by adding a dummy variable which takes on a value greater than the one when the two countries being observed belong to the union but is equal to one otherwise. The parameter estimate for the dummy then reveals the extent to which integration increases trade between two countries over the level that would exist between the two if they did not belong to the same integration scheme.

Hewett estimated Equation 1 using 1970 data for the members of the CMEA, the European Economic Community (EC) and the European Free Trade Area (EFTA). He found that the CMEA did, indeed, increase inter-member trade, to the extent that intra-CMEA trade volumes were somewhere between the level of trade expected between two western countries that do not belong to the same integration scheme and that expected between two western countries that belong to an integration scheme such as the EC or the EFTA.

Brada and Mendez (1985, 1988) undertook a similar study that included a larger sample of countries, the members of the CMEA, EC, EFTA, the Central American Common Market (CACM), The Latin American Free Trade Area (LAFTA), the Andean Pact and 18 developed and developing countries unaffiliated with any integration scheme, and they extended the analysis over the 1960s and 1970s. They also modified equation 1 so that the trade-increasing effects of integration were assumed to depend on the level of development and the distance between the integrating countries. This modification permited them to estimate whether, given their level of development and inter-member distances, the CMEA countries should expect integration to increase the volume of trade among them by as much as trade increased among the members of the EC and EFTA. Table 2 indicates that the CMEA's potential for increasing inter-member trade is less than that of the EC, in part because of the lower level of development of the CMEA countries and in part because of greater inter-member distances. On the other hand, the CMEA's potential is about that of the EFTA, with CMEA's lower level of development offset by EFTA's greater inter-member distances.

Whatever the CMEA's potential for increasing inter-member trade might be, if ineffective integration policies are followed in order, for example, to meet the political objectives of the Soviet Union, then this potential is unlikely to be realized. The lower panel of Table 2 reports the ratio of actual to potential inter-member trade for the EC, EFTA and CMEA. The effectiveness of integration policy in the CMEA is no worse than that of the EC, with each scheme achieving about 60 percent of the potential increase in inter-member trade. Thus if increases in trade among members, trade creation, is a useful measure of the economic benefits of integration, then CMEA policies have achieved as much of the CMEA's potential for increasing trade among members as have the policies of the EC achieved for its members.

One of the criticisms raised against the use of trade creation as a measure of the CMEA's economic benefits to its members is that much of the increase in intra-CMEA trade represents trade diversion (Holzman [1976] Ch. 3). That is, by favoring inefficient CMEA suppliers at the expense of efficient western or developing country suppliers, CMEA integration causes its members to overtrade with each other and to undertrade with the rest of the world. Holzman makes several arguments for the hypothesis that the CMEA countries overtrade with each other as the result of trade diversion. One argument is that prior to the formation of the CMEA its members tended to trade very little with each other and therefore the increases observed as the result of the diversion of trade from normal pre-World War II patterns. However, those patterns can hardly be viewed as normal, both because of the effects of the depression on international trade, and, more important, because of the extensive system of barriers to intra-East European trade that existed in the inter-war period.[13]

A second argument for the existence of overtrading among the CMEA countries is that the volume of intra-CMEA trade is too high primarily at the expense of East-West trade. However, as we have just seen in Table 2, CMEA integration has not pushed inter-member trade closer to its potential than has the EC, where it is generally agreed that, with the exception of agriculture, trade diversion has not been a serious problem. The point can also be made in terms of actual trade behavior. Thus in Table 3 it is evident that the CMEA countries appear to be only marginally more inclined to import from each other than from non-CMEA sources than are the EC countries. Finally, it must be kept in mind that the low volume of East-West trade often offered as evidence of the CMEA's trade diverting effect may more properly be ascribed to Western trade policy discrimination against the CMEA in its early years and to the difficulties experienced by CMEA countries in exporting their manufactures to western markets.

B. Dynamic Gains from CMEA Integration

In addition to the static gains from increased trade that result from integration, such increases can also increase the growth rates of the output of member countries.[14] These dynamic effects take two forms, an increase in technological progress and a faster growth of inputs, particularly capital. Faster technological progress comes about from the benefits of specialization and economies of scale, increased R+D expenditures and better management. Faster rates of input growth result from higher levels of investment engendered by the broader opportunities offered by the larger market of the integrating countries.

To obtain some quantitative estimates of the magnitude of these effects Brada and Mendez (1988) investigated the dynamic gains achieved by six integration schemes, the CMEA, EC, EFTA, LAFTA, the Central American Common Market (CAM), and the East African Common Market (EACM). On the basis of production function studies they found that only two of these groupings, the CMEA and LAFTA increased members' rates of technical progress, although by very small amounts. The CMEA differed from the other integration schemes in that the members of the other schemes experienced increases in investment as the result of integration while investment among CMEA members declined as the result of integration. This rather anomalous result may reflect the fact that one of the objectives of CMEA integration was to coordinate investment among countries to reduce duplication and thus to lower the investment cost of industrialization.

C. CMEA as a Customs Union

The statistical evidence presented above suggests that the CMEA produces those benefits of integration that are amenable to quantification to much the degree that such benefits are generated by customs unions among western countries. Thus CMEA has some capacity for providing economic benefits for its members, and it is to be expected that the members of CMEA may wish to preserve it even if they no longer are forced to follow the political dictates of the USSR. Before turning explicitly to considerations of CMEA reform, it is necessary to examine precisely what is the underlying concept of CMEA integration and to evaluate CMEA performance in a broader, more qualitative, way.

CMEA integration proceeds not by the lowering of tariff and other barriers to the movement of goods, services and factors of production among members, but rather by means of a web of trade agreements, plan coordination measures, specialization arrangements and other largely bureaucratic steps that depend for their implementation much more on government decisions than on the responses of producers and consumers to price signals.[15] In view of the way in which the domestic economics of these countries function this is not surprising; rather, CMEA integration largely mirrors the domestic economic mechanisms of its members. Negotiations over CMEA trade flows and prices as well as over coordination of production, investment and product specialization are facilitated and regularized by the CMEA, which provides members with an international regime that reduces the costs of reaching such agreements and thus promotes trade and cooperation among members (Brada, 1988).

CMEA's price-setting mechanism, although cumbersome, is an important component of the integration mechanism. It encourages inter-member trade by providing price stability, a valuable characteristic for central planners, and, more important, an objective rule for setting prices. The latter is particularly valuable because bilateral trade negotiations between two CMEA members are, in fact, negotiations between bilateral monopolists. In such a situation, equilibrium prices are difficult to settle, and the existence of an agreed-to starting point clearly must facilitate agreement and thus reduce the cost of trade. This benefit comes, of course, at a cost. Fixed prices, set to world market levels with little account for quality differences do, in fact, lead precisely to the kind of subsidies observed by Marrese and Vanous. In part these subsidies arise because, by the very construction of CMEA prices, there will be differences between them and continually changing world market prices. Moreover, as in any customs union, there will be differences between inter-member and world market prices that reflect differences in tastes and factor endowments between members and the rest of the world. Within CMEA, capital is scarce and the demand for capital-intensive products high relative to the rest of the world. Thus it is not surprising that countries such as Czechoslovakia and the GDR, which are more abundantly endowed with the scarce and highly demanded factor, benefit most from the difference between intra-CMEA and world market prices.

The CMEA has other shortcomings as well, but these reflect not so much flaws in the design of the integration mechanism itself as limitations imposed on integration by the economic systems of the integrating countries. For example, CMEA monetary arrangements have been unsatisfactory, largely because there is no universally acceptable means of settling trade imbalances between countries. Thus such imbalances are minimized and settled on a bilateral basis, imposing limits on both the volume of trade and on capital flows among countries. However, it is difficult to see how, under the classical system of central planning, the "commodity inconvertibility" of national currencies could be overcome in a practical way.

Another failure of CMEA integration is that it does not allow for the activities of CMEA based multinational firms. The lack of such firms limits integration to commodity trade and prevents the exploitation of the many sources of competitive advantage to be found in unique and firm-specific innovations or skills. The uniqueness of such firm-specific advantages makes it difficult for their owners to sell them to outsiders, and thus multinational firms arise to exploit them in other countries by establishing operations abroad rather than by selling their technology to foreigners or by exporting it. In many cases these firm-specific advantages arise in non-tradable products such as services rather than in tradables, and it is especially in such cases that CMEA integration is powerless to promote cross-country movement of skills and technology.

Finally, CMEA integration is based more on political and less on economic competition. Specialization, and the ability to capture export markets within the CMEA, is based much more on a political calculus of give and take than on the legitimate competitive potential of each country's producers. Thus, there is anallocation of competitive positions followed by extenseive development of production facilities, but little objective verification that specialization positions have been effectively developed to a competitive standard and surely even less elimination of wasteful and inefficient capacity.

Nevertheless, granting these shortcomings in CMEA integration, it is conceivable that as the economic mechanisms of the CMEA's members are reformed, these negative aspects of CMEA integration can also be reduced or eliminated while at the same time a number of the positive benefits that CMEA currently provides can be retained.

IV. The Future of the Council for Mutual Economic Assistance

A. The Future Environment of the CMEA

The type of reform that can be implemented within the CMEA will depend critically on the reforms that will be undertaken by its members to marketize, privatize and decentralize their domestic economies, because any regime promoting integration among countries must reflect and be consistent with the economic mechanisms of the integrating countries. At the same time the characteristics of the mechanisms promoting integration must reflect the possibilities and incentives for member countries' interactions with the rest of the world.

The pace of domestic economic reform has accelerated in all CMEA member countries, but, nevertheless, important differences remain both in the conception of reform measures and in their implementation. The most advanced reform measures have been proposed or are under discussion in Poland, Hungary and Czechoslovakia. There the reforms explicitly call for marketization and privatization. Nevertheless, it would be quite wrong to assume that progress toward these objectives will be as rapid as the reform blueprints at times suggest. Poland has, to a large extent, freed prices and elimated or reduced many producer and consumer subsidies. This "big bang" approach to price liberalization, however, was facilitated by the fact that Poland had already suffered from high rates of inflation for years and that Poland's external payments situation clearly called for serious measures. The fact that Poland has a large private agriculture that is unsupported by state subsidies also facilitated price liberalization, since the issue of food subsidies is a critical barrier to price liberalization in other planned economies. Nevertheless, it is important to bear in mind that many prices continue to be controlled, including those of coal and other energy sources and an incomes policy, is in place, limiting price flexibility. In Czechoslovakia and Hungary the pressure for price reform is less intense, and while reformers talk of either reform, meaning a realignment of relative prices, or a price liberalization, meaning decontrolling prices and leaving the market to determine their levels, there are serious obstacles to a rapid and wholesale liberalization. The principal one is that price liberalization is likely to be inflationary because agricultural prices, subsidized at both the producer and consumer level, would rise and industrial product prices probably would prove to be inflexible downward due to the monopolistic structure of industrial production. This inflationary surge could, in the opinion of many policymakers in these countries, set off an uncontrolable inflationary spiral. It would also impact primarily on low-income individuals who spend much of their incomes on food, cause unemployment and require a restructuring of production that would entail enormous short-run dislocations. Thus in the most reformist of CMEA countries, prices are likely to remain distored for at least 8-10 years, thus making such prices of dubious value in guiding foreign trade decisions without the aid of an elaborate system of tariffs, subsidies and other ad hoc levies.

In the Soviet Union, Romania and Bulgaria the liberalization of prices is unlikely at this time. In the Soviet Union, the so-called ruble overhang, the pent-up purchasing power in the hands of the population, represents an important barrier to the freeing of prices as do concerns over the effect of food-price increases. Moreover, in none of these countries is the conception of reform such as to make price liberalization or price reform necessary.[16]

Privatization and the consequent implications for enterprise autonomy and increased dismantling of extensive subsidization of firms will also be impossible to achieve rapidly. All countries where privatization has been considered have eschewed the wholesale privatization of industry and agriculture through some form of national distribution of ownership rights to the population.[17] Instead, incrementalist schemes such as the sale or leasing of enterprises to foreigners or domestic residents and the distribution of ownership rights to workers, municipalities, etc. have been viewed as more appropriate. Given the virtual non-existence of credit markets, the only domestic resources available for the purchase of assets from the state are private savings. Since these are, in most countries, a fraction of the value of the productive assets held by the state, then in privatization, as in marketization, progress will be gradual. In Poland, Hungary and Czechoslovakia, state enterprises will be converted to joint-stock companies, but the state will remain the principal shareholder. Privatization will proceed through the gradual sale of stock to residents, the distribution of shares to workers, foreign investments and the growth of new, privatley owned, business. Nevertheless, even in the most reform-oriented economies a period of 10 to 15 years will be required before the private sector will become predominant, and in the interim state-owned industry will continue to dominate the economy, albeit under different conditions so far as subsidies and prices are concerned. In countries such as the USSR, Romania and Bulgaria, the sell-off of the bulk of state-owned industry is not contemplated and thus the private sector will be relegated mainly to the service sector and thus outside the ambit of foreign trade.

In sum, the economic systems of the CMEA member countries are more likely to evolve over the next 10 to 20 years toward some form of a half-way house between social ownership and planning and private ownership and market based economies, at least if the current set of reformers are able to retain power and implement their reform programs.[18] This gradual reform, coupled with what has been a political revolution in politics in these countries, will create a genuine test of past views of the CMEA. If the CMEA is seen as having has been primarily a political creature of the USSR, then the political revolution in East Europe and the Soviet Union's political decoupling from East Europe should lead to the collapse of CMEA if not as an organization then certainly a an instrument for facilitating trade among its members. On the other hand, if the CMEA is seen as having fulfilled a useful role in promoting trade among incompletely marketized economies, then its members may well be willing to seek means whereby it can be reformed so as to retain its positive features while overcoming past shortcomings as reforms within CMEA members permit.

An important external factor on the CMEA members' ability and willingness to reform the CMEA in order to better meet their needs will depend on the terms under which they can engage in trade with non-members. The most important aspect of CMEA's external environment will be the relations with the European Community. Partly, the EC's impact on East European behavior is psychological. The CMEA has a long history to reacting to EC integration measures, and the expansion of the Community and the impending strengthening of EC integration in 1992 are both an attraction to the small East European countries because of the highly touted if somewhat unrealistic assessments of the positive effects of 1992 on EC economies and a perceived threat that, unless East Europe acts decisively now, it may be shut out of West European economic and political integration. Clearly the worldwide swing away from the Europessimism of the early 1980s has an important impact on East European attitudes as well. Czechoslovakia, Hungary and Poland have all indicated a desire for more intimate associate status with the EC with a view toward eventual full membership.

While there is no doubt that East-West trade and investment flows will increase, not only for these three countries but for the other CMEA countries as well, it is also evident that reformers in these countries are engaging in a good bit of self-delusion by believing that such an expansion of East-West contacts will be a panacea for their economic problems. First of all, many of these countries are in deep disequilibrium in their relations with the West, a disequilibrium characterized by extensive hard currency debts and by a trade structure that is inclined toward a more rapid growth of imports than of exports.[19] Second, many of these countries continue to express a preference for an industrial and export structure than may be at odds with what can be realized in economic competition with the West.

There are also likely to be some reservations on the part of the EC, which will, of course, seek to increase its trade and investments in CMEA, but which may well wish to stop short of moving toward as intimate relationship with East Europe as the East Europeans may hope for. In part this reluctance will be based on political factors. Nowhere in East Europe has there been a functioning democracy. Amorphous national coalitions have replaced the Communist Party, but it is premature to predict that viable multiparty democracies will emerge in due course. Until a solid record of political stability can be established in East Europe, a process that will take at least ten years, and perhaps even more in some countries, it is unlikely that the EC would be willing to extend full membership to any CMEA member. In addition, economic obstacles to an intimate relationship between the EC and CMEA countries will exist for many years. As the EC becomes more integrated the problem of incorporating new members or associates will grow, and thus the EC will scrutinize potential new members for economies whose mechanisms generally conform to those existing among the current EC members. As discussed above, a transformation of the CMEA economics to such an extent is only a long-term proposition. It is amply evident that the addition East European members to the EC would be a drain on EC funds; both to support the large and inefficient agricultural sectors of these countries and to assist their backward regions. Finally, the addition of East European countries with their hypertrophied smokestack industrial sectors would exacerbate structural adjustment and unemployment problems in West Europe's iron and steel, mining and metalworking industries.[20]

Thus the centrifugal forces acting on CMEA are likely to diminish as East and West reach a more realistic assessment of the possibilities while the centripetal forces will increasingly assert themselves as the CMEA countries turn from the dismantling of communism toward the more practical problem of creating functioning economic systems on the ruins of central economic planning. If the CMEA is to be retained but reformed to reflect its external environment and the evolving economic systems of its members, then it is worthwhile to consider several alternatives that have been proposed as potential models for a new CMEA.

B. A Dollarized, Marketized CMEA

One model of CMEA reform, proposed by Hungary and more recently, and with greater fanfare, at the Sofia meetings of the CMEA by Czechoslovakia's Finance Minister, Vaclav Kluas, is a CMEA that undertakes trade at world market prices and pays for it in hard currencies. Indeed, Hungary and the USSR have agreed, in principle, to conduct their trade on this basis in the future.

The proposal sounds appealing for several reasons. First, by setting prices equal to world market prices it avoids the distorting effects that existing differences between intra-CMEA and world market prices now create. That is, for the Soviet Union, raw materials exports and manufactured goods imports from East Europe would no longer represent a burden. For East Europe, trade at world market prices would bring rationality in energy prices and, more important to East European reformers, would show the true benefits and costs of exporting to the USSR. That is, as East European manufactured goods exports to the USSR are re-priced at new, lower, prices, the attractiveness of exporting to the Soviet Union would decrease, and producers would redirect their efforts toward western markets. Second, by paying for imports and exports in dollars, trade surpluses in the CMEA could be utilized in trade with other countries.

There are, nevertheless some shortcomings to this "big bang" approach to CMEA reform. The first is that in theory it represents a tremendous gain or the Soviet Union, since Soviet oil is now priced within CMEA at world market prices while East Europe's manufactures are overpriced. Thus, at world market prices Soviet trade with the rest of CMEA would show a surplus of $11 billion rather than a deficit of $4 billion according to Soviet calculations. In addition to the terms of trade loss imposed on East Europe, the payment for imports and exports in dollars would generate both an increase in the transactions demand for foreign exchange in each country as well as a greater reserve demand as the volume of hard currency denominated trade increases.

A further difficulty is that precisely by placing intra-CMEA trade on a par with trade with non-CMEA members, the integrating effects of CMEA are effectively eliminated. That is, if for one CMEA country trade with another CMEA country is to be conducted at the same prices and in the same currency as trade with the rest of the world, then there remains, in fact, no integrating effect to stimulate intra-CMEA trade.

The proposal also suffers from a number of practical problems. Not the least of these is the determination of world market prices for East European manufactures. It is easy to argue that low quality East European goods are overpriced in intra-CMEA, trade but there is no objective way of determining what the world market price for such goods might be. Indeed, unless CMEA is to conduct its trade on the basis of cumbersome efforts to document the world market prices of East European manufactures, intra-CMEA prices must be based entirely on bilateral negotiations within CMEA. Such a practice is more time consuming and cumbersome than the existing system, thus serving to reduce intra-CMEA trade.

If trade takes place at some approximation of world market prices, domestic firms will only respond to the extent that market prices are passed on to domestic producers. While some reforms in this direction are under consideration, it is instructive that while Czechoslovakia's Finance Minister was speaking out in favor a marketized CMEA, official Czechoslovak reform proposals were contemplating a system of "state orders" to be imposed on Czechoslovak enterprises in order to force them to fulfill CMEA obligations. If firms are to be forced to trade by state orders, then there is little room left for the incentive effects of prices. Finally, although the Soviet Union stands to gain through an improvement in its terms of trade, such an improvement would, in fact, militate for a shift in productive resources from industry, the import competing sector, to natural resources, the export sector. Indeed, in a dollarized world-market priced trade, the resource rich Soviet Union's industry would be the victim of a particularly virulent form of Dutch disease.[21] Exports of manufactures, a priority of the Soviet leadership, would decline sharply.

In sum, the dollarization of CMEA trade is likely to proceed very slowly, with hard currency payments reserved for a small fraction of total trade. If the reform of the CMEA economies does not proceed further than suggested above, price signals generated in dollarized intra-CMEA trade would pass through to the domestic economy only by way of decisions made by central authorities. Thus there are minimal gains in efficiency and potentially large losses from the disintegration of the CMEA.

C. Reforming the CMEA to Evolve into an Economic Integration Scheme

If the CMEA cannot be turned into a marketized and dollarized customs union quickly it is worthwhile examining proposals for CMEA integration that move toward this goal in a more gradual, evolutionary way that is more consistent with the pattern of reform in the member countries.

One such proposal has been put forward by Jozef van Brabant (1988), who suggests a mechanism reminiscent of the European Payments Union (EPU) for promoting a form of intra-CMEA convertibility and thus increasing both the volume and the economic efficiency of trade among members. Van Brabant proposes to expand the idea, already approved by most CMEA members, of direct inter-enterprise relations between enterprises in two or more CMEA countries. He suggests that each CMEA member establish a maximum for the total value of such inter-enterprise exchanges and that any transactions falling within this limit be cleared automatically and anonymously. Clearing would take place through a special facility, established with the International Bank for Economic Cooperation. Exchanges above these established limits would be cleared through existing CMEA clearing mechanisms. In this way an organic link between enterprises in different countries can be established, serving as a micro-economic and non-bureaucratic impulse for CMEA integration. Imbalances between countries would be settled by establishing a hard currency fund to which all members would contribute. Surplus countries could cover their surpluses by borrowing hard currency from the fund; deficit countries would eventually have to make additional contributions. Such a scheme would retain and expand the pool of hard currency while providing for the multilateral offsetting of trade imbalances. Both these elements are critical improvements over a scheme where balances are settled bilaterally, leading to various forms of log-rolling over trade and prices, and over a scheme where the hard currency contribution is simply absorbed by those countries who are able to run a surplus in the beginning. This limited form of convertibility proposed by van Brabant can be expanded as the range and scope of interfirm operations expands. Thus the scheme not only strengthens intra-CMEA integration by giving it an economic basis, but also provides the benefit of an increasingly convertible currency for member countries.

Another way of approaching intra-CMEA integration and convertibility is to approach the problem from the final product level. Like the van Brabant proposal, this approach to reforming the CMEA mechanism meets the realistic needs of its reform oriented members for a more market-oriented basis for their trade while at the same moving their currencies toward convertibility. It is also consistent with the distorted price structures and excess demand for consumer goods that exists within member countries as well as with the asymmetric manufactures-for-fuels and raw materials nature of Soviet trade with other CMEA members. Finally, this proposal reform does not require the participation of all members; rather only those countries that wish to trade under the new regime need do so, all others can continue to conduct their CMEA trade either under existing arrangements or by other, bilateral, arrangements.

There are two preconditions for such a reform of the CMEA mechanism: the dismantling of the state's monopoly over foreign trade and the devolution of trading rights to individual enterprises. At the same time, reforming countries must attempt to equilibrate their consumer goods markets, particularly the markets for manufactured goods, and to have prices for such goods more accurately reflect the costs of production. As discussed above, in the near future even the most reformed CMEA economy will continue to display tremendous distortions in prices and the pattern of production. The consumption of agricultural products will continue to be heavily subsidized, with retail prices remaining below the prices paid to agricultural producers. Fuels and raw materials will continue to be priced substantially below the cost of obtaining them domestically or through imports, and capital goods will also be underpriced domestically. This pattern of subsidization and the extent of both macro- and micro-economic distortions will continue to vary widely from one CMEA member to another. Such a pattern of distortions be eliminated by domestic reforms alone, since domestic prices must reflect trading opportunities as well as domestic resources and demands, particularly for the smaller CMEA members.

Because of these distortions in each CMEA members economy, it would be impossible to attempt to engage in a reform of the CMEA trading mechanism that covered all commodities even if all CMEA members would be willing to attempt such a reform. A more feasible, yet far-reaching, reform would be to marketize trade in some commodities while maintaining the existing CMEA system for trade in other commodities. Fuels, raw materials and agricultural products would constitute the bulk of the goods that would continue to be traded on the basis of the traditional system of long-term, state-to-state agreements. In the case of fuels and raw materials it is unlikely that the importing countries would be willing to yield decisions over such strategic inputs to enterprise-to-enterprise contacts. Moreover, to make the importation of such commodities profitable to firms would require either massive subsidization of importers, with its attendant inefficiencies, or an increase in the domestic prices of fuels and raw materials and the consequent inflation of all prices. In the case of agricultural products both the desire to maintain adequate supplies for domestic consumption and the subsidization of the consumption of food argue against dismantling the existing system of state-to-state trade. Since producer prices are higher than consumer prices in all CMEA agricultural sectors, few firms would be willing to import food purchased at the wholesale prices of another CMEA member if it were to be sold at the retail prices of the importing country. On the other hand, no CMEA country would be willing to export many agricultural products if foreign enterprises were to purchase them at retail prices since sales at these prices are highly subsidized. Thus, both within each CMEA country and in CMEA trade, fuels, raw materials and agricultural products would be produced, bought, sold and traded by traditional means, mainly at fixed prices. For these "fixed-price" goods, the existing arrangements are simply too costly to dismantle at this time.

Consumer manufactures and capital goods would make up the so-called "free-price" goods. These goods would be traded on an enterprise-to-enterprise basis at prices that would be negotiated between the buyer and seller. Consumer goods could thus be imported either by retail establishments for sale to the general public or by producing enterprises for sale to their own workers. In this way the effort to develop a functioning internal market and to stimulate competition on national markets that are often monopolized or oligopolized would be materially aided by the foreign trade sector. Moreover, competition from socialist enterprises in other CMEA countries would be "fairer" and more equal competition than that provided ;by imports of western goods where the preferences of the buyers would be overwhelmingly for the western good.

Prerequisites for such enterprise-to-enterprise trade on a large scale, rather than on the very limited scale now being attempted with the CMEA, are the creation of internal markets for these goods and the development of a monetary regime that would permit enterprise-to-enterprise transactions in national currencies to take place. The development of domestic markets is perhaps the most daunting barrier since it is commonly believed that there is significant excess demand for consumer goods in all the CMEA countries. Nevertheless, it should be borne in mind that a large part of this excess demand makes itself felt on the markets for foodstuffs, housing, services and certain consumer durables such as automobiles. At the same time there are many consumer manufactures such as clothing, footwear and some consumer durables that, given the assortment and quality of their production within the CMEA, are in adequate if not excess supply. Thus, with foodstuffs a fixed-price good and housing and services not traded, the creation of a genuine domestic market for consumer manufactures may be quite feasible. For those consumer manufactures, such as automobiles, that are in short supply, tariffs can be erected to limit the volume of imports. In the case of capital goods the current austerity measures and investment cutbacks in most CMEA countries would appear to have created a situation where the supply of machinery and equipment, especially of the less sophisticated and more standardized variety, may also exceed available demand.

The monetary regime required to implement such a scheme is quite simple. Enterprises in each CMEA country participating in this scheme would be permitted to buy and sell free-price goods in any other CMEA country participating in the scheme. The foreign exchange, that is, the domestic currency of other CMEA countries, earned through the export of free-price goods could be converted into domestic currency by the national bank of the exporter's country. Similarly enterprises seeking to import free price goods can do so either by offering to pay in the importing country's currency or by purchasing the exporter's currency from the importer's national bank. Thus each country's national bank would hold reserves of the currency of each of the other participating countries and would fix a rate at which it would buy and sell its currency against that of the others. If one country found itself with an undesirable surplus or deficit in a particular currency it could eliminate it either through a currency swap with another central bank or it could change the exchange rate.[21] The use of inter-bank swaps of currencies at the going exchange rate would avoid the problem of bilateral balancing of trade between CMEA members. The ability to change the exchange rate effectively prevents those countries that suffer most from repressed inflation from "exporting" it to other participants by running large trade deficits. Instead, the currencies of such countries would depreciate while the currencies of countries that have achieved equilibrium in their domestic markets would appreciate.

Trade in fixed-price goods would be carried out much as it is now. CMEA members would engage in bilateral negotiations that would result in long term agreements specifying the quantities and prices of such trade. To the extent that trade in fixed price commodities did not balance between any two countries, the deficit country would then pay in its domestic currency, thus providing the surplus country with the means of paying for imports of free-price goods. Similarly, trade in free-price goods between a CMEA member adhering to the reformed system and a member adhering to the old system of trade could be accommodated. The two countries would negotiate a bilateral trade agreement, specifying quantities and prices. In the country with the reformed trading system a trading company would be charged with buying the appropriate amounts of free-price exports, competing with other buyers on the domestic market for such goods. Similarly the trading company would have to sell the planned imports on domestic markets for whatever prices could be obtained. In this way domestic markets would retain their allocative function without forcing all CMEA members to adopt the new trading regime.

The CMEA could also develop new institutions or modify existing ones to make the reformed trading system function more smoothly. One problem will be that the prices of consumer manufactures and capital goods may evolve quite differently in the short run. Thus depending on whether a country is a net exporter of consumer manufactures or of capital goods it may experience an improvement or deterioration of its terms of trade. A fund to provide compensation for losers might be organized along the lines of the European Community's Common Agricultural Policy. All CMEA members would contribute to the fund while those suffering the largest terms of trade losses would be compensated. Such a measure should, of course, be seen as a transitional one, to be phased out over an agreed-upon period of time. Another useful role for a CMEA institution would be to create an auction where members' central banks could sell and purchase the currencies of other members according to their reserve needs. Since such currencies would now freely convertible into free-price goods, the commodity inconvertibility that plagues the transferable ruble would be avoided.

The proposal has a number of desirable features. First it is feasible in that it can be adopted under the CMEA's "interested countries" principle, thus avoiding the need to have reform of CMEA trade tied to the pace of its least reform-minded members. Moreover, the domestic reforms required to achieve this limited form of convertibility are modest. From such undemanding measures a great deal of good can result. Domestic production and intra-CMEA trade in free-price goods will be rationalized, creating greater efficiency, competition and the allocation of production according to the principle of comparative advantage. Consumers will also benefit, not only from a wider choice among goods but also because the surpluses of one country will be available to reduce the shortages in another. Making each of the currencies of CMEA members at least partially convertible into goods would do much to eliminate the problems of bilateralism, commodity inconvertibility and the issues of hard goods vs. soft goods that currently plague the CMEA. Finally, the effort to establish convertibility within CMEA would entail much less dislocation and much less pressure on the economies of these countries than would an effort to first achieve convertibility against hard currencies such as the dollar and the yen.

The fundamental difficulty with both the proposals examined in this section is that both require resources and a concerted effort at CMEA reform to make them function. Given the current political climate within the CMEA, with the Soviet Union adopting a policy of benign neglect toward Eastern Europe and Eastern Europe viewing a turn to the West as a panacea for many of its problems and trade with the Soviet Union largely as a source of problems, there seems to be little impetus for serious and constructive efforts to do more than to salvage those elements of exiting CMEA integration that can be retained without much additional effort.

D. A Realistic Future for the CMEA

If the members of CMEA simply put all their efforts into improving their economic relations with the West, then the main effect will be a failure to develop new and effective means of intra-CMEA integration. Trade flows will change much less in the near future; Eastern Europe will continue to require imports of fuels and raw materials, and if Soviet exports of these commodities are redirected toward western markets then these or the identical goods from other suppliers will find their way to Eastern Europe. Similarly, the Soviet Union will continue to import manufactured goods and it is not conceivable that all imports of Polish Fiats will be replaced by West German Porsches or Hungarian television sets by Japanese Sonys. Even if some East European exports are diverted to the West, past links and economic structures will maintain a large part of East European-Soviet trade flows intact.

What will disappear most quickly are the long-term non-market elements of so-called socialist economic integration. These involve extensive long-term investment plan coordination agreements among CMEA members that have the objective of speeding technological progress on the basis of national specialization. A further component of this effort has been a series of large scale joint investment projects, most often to develop natural resources on the territory of the USSR. These programs have been both unpopular among CMEA members and generally unsuccessful. If this were not sufficient to doom them, the reform of a number of CMEA members away from planning would surely complicate long term plan coordination efforts. The principal reason why virtually all CMEA members wish to do away with these programs is that they wish to adopt structural policies geared not to the needs of the CMEA, and particularly the Soviet, market, but rather toward the needs of the world market. Thus long-term investment coordination is both ineffective and irrelevant to current economic objectives, and its supporters within CMEA will not be able to keep it alive in its current scope.

The CMEA has also adopted a series of micro-level integration measures including direct links between enterprises and the direct settlements of trade in national currencies, a form of intra-bloc convertibility for certain transactions. These measures are hampered by unresolved problems of enterprise autonomy and differing national price systems, and they will at best account for a small share of intra-CMEA trade. Another part of intra-CMEA trade will be lost to transactions cleared in convertible currencies, although it is unlikely that hard-currency clearing will become the predominant mode of payment in the CMEA in the near future. Thus what will remain of the CMEA mechanism is its basic core, government to government negotiations and agreements over bilateral trade flows, at prices set by the partners at prices near, but not necessarily at, world market prices. The volume of this trade will be reduced, but greater flexibility will exist for intra-CMEA exchanges above these quotas. These above-quota transactions will be traded at world market prices and cleared in convertible currencies in direct competition with East-West transactions.

Nevertheless, these transactions are unlikely to account for the major share of intra-CMEA trade rather they will be supplementary to bilaterally negotiated trade flows. Consequently, like the economies of its members, CMEA trade will be more marketized than now, but still tied to the legacies of its socialist, centrally planned past.

Footnotes

[1] The CMEA for example, was founded as a reaction to the Marshall Plan and the European Free Trade Area (EFTA) was organized in response to the formation of the European Economic Community (EEC).

[2] Marer (1974) provides a useful survey of the measures employed and economic costs involved in Soviet exploitation during the late 1940s and early 1950s. At the same time, it cannot be argued that the creation of the CMEA in 1949 either facilitated or increased this exploitation. Indeed, neither western nor socialist specialists are able to offer compelling explanations for the establishment of CMEA (Kaser [1973], ch. 2, van Brabant [1980] Ch. 1. The original objectives of the organization, exchanges of experience among members, extending technical aid and rendering mutual assistance, were surpassed in their modesty only by the concrete results achieved by CMEA in this period.

[3] For a good summary of western views, see Holzman (1976) Ch. 3. For a candid assessment from the Soviet standpoint, see Institute of the Economics of the World Socialist System (1988) which sums up the new Soviet view of CMEA thus:

"Integration in CMEA took an administrative-bureaucratic route. Instead of working for a true economic partnership..., spurious and pretentious measures and projects were substituted by the higher...echelons. The process of integration was reduced to one of bureaucratic organization of economic interaction among the state systems of self-contained...countries which were separated from one another by...financial, economic, legal, and other barriers."

[4] Holzman (1976, p. 59) sums up the Western view by asserting that "...it is safe to infer that CMEA is a losing proposition in economic terms."

[5] The low volume of pre-socialist trade among countries in the CMEA is often cited as evidence that it does not constitute an appropriate integration scheme. Montias (1966), however, points out that policy barriers rather than resource endowments or economic structures may explain this low volume of intra-regional in Eastern Europe.

[6] For some estimates of the costs of such bilateralism, see van Brabant (1973).

[7] Moreover, the political power of the Soviet Union may have induced East European trade officials to adopt a "soft" approach to negotiations over prices with the USSR. That one of the charges leveled against Rudolf Slansky during the Czechsolvak show trails was that he was a hard bargainer in trade negotiations with the Soviets may have been instructive for trade officials in other countries. On the other hand, if this change against Slansky had any validity, then it is evident that market power may not have been on the Soviet Union's side.

[8] Discrimination against the CMEA took the form of tariffs and quotas but derived as well from the marginal nature of CMEA involvement in western markets and the difficulties of doing business with planned economies that were built into East-West prices.

[9] For a full exposition of these arguments see Brada (1985, 1988).

[10] Compare, for example, Marrese and Vanous (1985) Ch. 8, Marrese (1986) and Marrese and Vanous (1988) for rather different views of the subsidy setting process and the way in which political payoffs are generated.

[11] In the early 1980s, on the other hand, subsidies decreased despite the collapse of detente and increasing super power tension and a competitive arms build up by the US and USSR.

[12] The per capita amount of the subsidies is also rather unimpressive. See Brada (1985, p. 87) and (1988, p. 643).

[13] For an analysis of these barriers and their implications for the subsequent integration of East Europe through the CMEA, see Montias (1966).

[14] For a discussion of dynamic gains, see Kreinin (1964).

[15] For an examination of integration measures in CMEA see Lavigne (1988).

[16] I do not discuss the reforms of the GDR as it is likely to be reunited with the Federal Republic of Germany most probably along the lines of the FRG's economic system. Nevertheless, given the GDR's strong economic ties with the Soviet Union, there may develop strong bi-lateral relations between the two nations based on a mix of market and non-market mechanisms. Such mechanisms may serve as useful models for the eventual marketization and monetization of CMEA relations as well.

[17] A wholesale privatization would proceed by distributing portfolios of shares in nationalized firms or vouchers that would enable residents to bid for such shares. The advantage of this procedure is that it would immediately privatize all social property that the state deemed suitable for privatization and at the same time create the conditions for a functioning capital market.

[18] One must be cautious on this point. The national-front nature of the opposition movements in Eastern Europe of course dictates policies that are incrementalist and that do not impose severe burdens on any segment of society through their reform programs. Once the front evolves into independent political parties that compete for power by articulating the interests of specific social groups such as farmers or workers or entrepreneurs, then the pressure for more radical change may emerge.

[19] In particular, East European exports to the West tend to be income inelastic and subject to successful; competition from newly industrializing countries, see Poznanski (1986), while their imports from the EC tend to be more income elastic.

[20] The experience, should it occur, of German reunification would serve as an interesting dress rehearsal for the affiliation of other CMEA countries with the EC.

[21] Note that although the exchange rate between the currencies of countries A and B would be set independently by their two central banks, transactions would only be made at the more favorable rate, thus creating a single exchange rate between A and B.

Table 1

THE SOVIET UNION IN THE CMEA (1988)

Country	GNP (billion $)	Population (million)	Percentage of Total Exports Directed Toward USSR
Bulgaria	67.6	8.97	61
Czechoslovakia	158.2	15.66	43
German Democratic Republic	207.2	16.59	N/A
Hungary	91.8	10.57	48
Poland	276.3	38.17	25
Romania	151.3	23.15	27
Total	952.4	113.11	
			Percentage of Exports Directed to CMEA
USSR	2500.0	288.7	50

Sources:
Central Intelligence Agency, The World Factbook 1989 (Washington: Central Intelligence Agency, 1989) and Czechoslovak Chamber of Commerce and Industry, Facts on Czechoslovak Foreign Trade, (Prague: Czechoslovak Chamber of Commerce and Industry, 1989).

Table 2

ESTIMATES OF POTENTIAL AND ACTUAL INCREASES IN INTER-MEMBER TRADE FOR EUROPEAN INTEGRATION SCHEMES

Multiple By Which Inter-Member Trade Would Increare Under Equally Effective Integration policies

Year	EC	EFTA	CMEA
1970	8.6	5.5	5.5
1977	6.6	4.6	5.2

Ratio Of Actual To Potential Increase In Inter-Member Trade

Year	EC	EFTA	CMEA
1970	0.59	1.03	0.55
1977	0.59	0.91	0.59

Source: Brada and Mendez (1988).

Table 3

Inter-Member Imports as a Share of
Total Imports in the CMEA and the EEC, 1980

Country	CMEA Inter-Member Imports as % of Total Imports	Country	EEC Inter-Member Imports as % of Total Imports
Bulgaria	77.06	Belgium-Luxembourg	63.14
Czechoslovakia	65.89	Denmark	49.23
GDR	40.74	FRG	47.77
Hungary	47.34	France	46.29
Poland	53.28	Greece	39.69
Romania	31.26	Ireland	74.51
USSR	48.21	Italy	44.27
Average	51.96	Netherlands	53.64
		United Kingdom	38.65
		Average	50.80

Sources: Vienna Institute for Comparative Economic Studies, Comecon Foreign Trade Date, 1982, and Eurostat Review, 1971-1980.

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"TRY A DOSE OF PRIVATIZATION AND SOME FREE MARKETS...AND IF YOUR ECONOMY ISN'T WORKING BETTER TOMORROW CALL BACK"

by

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Economists who study the countries of Eastern Europe have known all too well the shortcomings of central planning, but until recently there was nothing that they could do about it. Of course, they did have the solution to the slow growth, technological obsolescence and inefficient factories that plagued these economies. Unfortunately, the solution, to transform the economic systems of these countries into ones where private ownership of resources provided incentives to use them efficiently and markets provided objective success criteria, was impossible to implement in countries ruled by Communists. Thus Western economists could offer little more than sympathy and suggestions for minor tinkering that would not offend Party ideologues.

With the collapse of Communist regimes in Eastern Europe, the limits on what was possible in the way of economic reform disappeared, and Western economists, some invited others not, arrived to provide advice. The most famous of these western advisors is Professor Jeffrey Sacks of Harvard University. His experience in curing sick Latin American economies made him a likely doctor to prescribe his version of the "big bang" all-at-once reform for Poland, which suffered from both Latin American style hyperinflation and crushing external debts. For other East European economies, such as Hungary and Czechoslovakia, the economic situation was not as bad as that of Poland, and thus less drastic medicine was in order. Moreover, reformers in those countries could take a less hurried view toward consultations with Western colleagues.

Participating in two formal East-West meetings that sought to develop reform proposals has taught me that privatizing and marketizing the East European economies will be a long and time consuming task, and that each country will probably follow its own path to reform. Nevertheless there are some common features of the reform process that can be discerned at this time.

My first meeting was that of the Blue Ribbon Commission, a joint Hungarian, American and European effort organized by Professor Paul Marer of Indiana University. The meeting was held this January at the Hudson Institute's headquarters, a former mansion outside Indianapolis. Twenty six Hungarian scholars, politicians and bureaucrats and some one hundred western academics, business people, bankers, government officials and politicians met for a week to work out a transition program for the new Hungarian government that will be elected this March.

Both the number of people and Hungarian politics made reaching consensus difficult. Certainly Hungarian politics was the main obstacle, because there are at least 51 political parties in Hungary, and public support is shifting in ways that neither politicians nor pollsters can predict. Thus picking among alternative solutions to any problem was difficult; the right solution would depend on which party won, or at least ended up in the ruling coalition. Offsetting this tendency to temporize were Hungary's economic problems: a huge external debt, domestic inflation that will be at least 20 percent this year by the government's own estimate (and more if the state of the black market exchange rate in Budapest is any indication) and a population fed up with 10 years of austerity policies that have solved none of Hungary's problems but have made life grim.

The second conference was a month later, held at a castle outside Prague. It was convened by the newly installed Czechoslovak government. Ten western economists of Czechoslovak extraction met with a larger government team headed by Vladimír Dlouhý, Chairman of the State Planning Commission. The objective was to discuss a draft of the government's plan for economic reform. The existence of a draft plan and the fact that the Civic Forum has formed a government and is expected to win the largest share of votes in the June elections helped focus the discussion, although at the cost of ruling certain approaches to problems out of bounds.

Privatizing the Economy

A controversial issue in both meetings was that of privatization. East European economists have recognized that property that belongs to everyone belongs to no one. With social ownership of capital there has been no pressure to use factories efficiently, to see that capital is directed toward those activities where it earns the highest return or to hold managers accountable for their business strategies. Thus creating private owners to replace the state is seen as a critical component of the reforms.

The difficulty is that the only value that exists for the enterprises now in the state's hands is book value. Book value, however, does not reflect economic value, meaning value of the profits that the firm can generate. The book value of the state's assets far exceeds the amount of money and savings that the population has. If the state tried to sell firms to the public for their book value, only a small fraction of state-owned capital would be privatized before the population's liquid savings were exhausted. Only by selling off firms for a fraction of their book value could the state hope to privatize them all. Nor can people borrow in order to purchase shares in these firms; there is no capital market and in any case such credit expansion would be inflationary. Two approaches toward privatization emerged that offered to overcome this problem.

The first of these might be dubbed the "peoples' capitalism" approach to privatization. Variants of this approach have been published by the Hungarian economist Tibor Liska, were raised by participants in the Hungarian meeting as well as by University of Pittsburgh economist Jan Svejnar at the meeting in Czechoslovakia. The essence of the proposal rests on the notion that, under socialism, the means of production already belong to the people and what remains is to get formal ownership rights into their hands and away from the government. That is, state firms would be converted into stock-issuing corporations and the stock would then be distributed to the population. Distribution might take place by having a computer generate diversified portfolios of shares that would be given to each citizen. Another possibility would be to give people vouchers with which to bid for shares of various companies. Risk averse individuals might bid for the stocks of public utilities while high fliers might take a fling at stocks of high tech firms. In this way all of industry could be privatized, and a functioning stock market with established share prices would spring up literally over night.

Whatever its virtues, this proposal was generally denounced as too academic and radical. Among the criticisms were that it does not raise money from the government - as if the government should benefit from giving people the property that it nationalized in their behalf.[1] Moreover, critics argued, some people would sell their shares and use the proceeds to buy goods, and therefore it is better the proceeds should go to the state which will spend the money in wiser ways than would individuals. Interestingly, this distrust of individual decisions was as pronounced among western participants as among those from Eastern Europe.

The alternative was a much slower denationalization where state enterprises are converted to stock companies, but the stock is held by the state. Only gradually would shares be sold off to the public, to insurance companies and pension funds and to foreigners. Special provisions would be made to sell shares at preferential rates to the workers of the firm by which they are employed. While this scheme has the advantage of raising funds for the government, it also has a number of drawbacks. The most serious is that, given the disparity between domestic savings and the value of firms to be nationalized, privatization through sales to the population will proceed very slowly, so that 10 to 12 years from now the bulk of industry could still be in government hands. Sales to workers, especially if they take some organized form such as an ESOP (Employee Stock Ownership Plan) may be fine for workers in modern plants producing products exported to the West. But what about workers in old steel mills producing steel plate exported to the USSR to build tanks? Forcing workers to invest in firms likely to go bankrupt in the new market environment is hardly calculated to produce enthusiastic supporters of the new capitalism. Finally, those best able to profit from this form of privatization are foreign buyers, since they can borrow money in international capital markets to purchase shares in whichever companies they find attractive, leaving the government stuck with the shares of the losers. Proposals to hold public auctions of state owned firms in order to sell them to foreigners at competitive prices are unlikely to assuage the public, which may resist the wholesale sell-off of public firms to opportunistic foreigners. Indeed, in Hungary where several such sales have taken place a spirited political debate about the future of such auctions has erupted.

Whatever the relative merits of these competing proposals, the latter is clearly more acceptable to policymakers in Hungary and Czechoslovakia. Western investors will thus have the opportunity to buy up industrial capacity and the realestate that is part of many firm's assets at bargain basement prices. At the same time, the rate of privatization in these countries will proceed quite slowly, leaving a large share of industry in government hands. This may become a serious problem, because there is no guarantee that the current governments will be any less resistant to firms' pleas for bailouts nor any wiser in their investment decisions than were the Communist governments that preceded them.

Creating Markets

The creation of functioning markets in Czechoslovakia and in Hungary faces two obstacles. The first is that the freeing of all prices would lead to huge increases in the prices of food products and other consumer necessities that are currently subsidized by the state. Such an increase in the price of necessities would have the greatest impact on low-income families and particularly on pensioners. Thus in both countries there is a great reluctance not to free agricultural prices immediately, but rather to phase in price increases over a period of five to ten years. Western economists generally argued against such a long phase-in of the new prices for several reasons. First, the longer prices continue to creep upward, the more an inflationary psychology is likely to take root. Second, so long as some prices are kept artificially low, the decisions to consume, produce or export agricultural products will be based on the wrong signals. In industry the concern is that liberalizing prices will cause large price increases because of the predominance of large firms that have either monopolistic or oligopolistic control over the national market. With no effective competition on the output side, the resulting market prices will be too high, leading to inflation and improper decisions on the allocation of inputs. Thus many Czechoslovak and Hungarian economists wanted to delay price reform until the large firms could be broken up to provide a more competitive industrial structure.

Westerners generally argued that to delay price reform until the industrial structure could be changed would take too long. Better, they said, to have prices that were determined by monopolized or oligopolized markets than to have totally arbitrary prices. At least, even if markets are monopolized, profits, even if excessive in some cases, would have some economic information. This argument seemed persuasive to our East European colleagues, at least to the extent that they shortened considerably the time period over which prices would be freed. Nevertheless, price distortions, pervasive in both economies, will continue well into the future and a major problem for new governments will be to deal with political pressures for retaining subsidies and other forms of price distortions that favor various consumer and producer groups.

Macroeconomic Policy

Czechoslovakia finds itself in a favorable macroeconomic situation. There is little open or repressed inflation and the government budget is in balance. At the same time, the new government wants to avoid triggering the kind of inflation that has plagued Poland and to a lesser extent Hungary. Thus Czechoslovak reformers want to run a government budget surplus, largely by reducing defense and administrative outlays and subsidies to loss-making firms. The banking system is to assist in controlling inflation by limiting the expansion of credit. Here an argument erupted over the age-old question of rules vs. discretion. Some economists argued that the State Bank should be bound by a rule that kept money supply growth at or below the rate of growth of output, a proposal, similar to that made by Nobel Laureate Milton Freedman for the United States. The Bank's staff argued for a discretionary policy that would let them react to current economic conditions, and in the end they prevailed.

In Hungary, also, the need for a deflationary policy is seen, in part because inflation is a serious problem and because the budget is in deficit. The problem in both countries is that price reform and marketization will cause unemployment and impoverishment of pensioners and others on fixed incomes. Thus a social "safety net" of unemployment compensation and increased welfare payments is needed. This will surely increase government expenditures. At the same time the privatization of economic activity will put a grave strain on the state's ability to collect taxes with a tax system geared to the existence of a small number of state-owned firms.

Western economists pointed to two dangers. The first was that an excessively deflationary policy would choke off possibilities for growth. Too many firms would go bankrupt, private entrepreneurs would be discouraged and there would be little new investment to restructure the economy. On the other hand, the new banking system has some inflationary risks built into it. In both countries new commercial banks have been organized for the purpose of lending to enterprises. It was hoped that the commercial banks would impose financial discipline on the firms by denying new credits to those that were not profitable. Unfortunately the old debts of these enterprises, often forced on them by central planners and never intended to be repaid without the aid of government subsidies, were passed on to the commercial banks. The banks are thus stuck with clients who are poor credit risks, but if the banks refuse to lend them more money, some of these firms will go bankrupt, and the banks will lose the entire value of these loans. Thus Czechoslovak and Hungarian banks are captives of their borrowers, much like western banks are captives of their developing country debtors. Both have to keep on lending to keep their clients from defaulting on past loans.

Foreign Trade

Perhaps greatest East-West agreement was to be found over the need for these economies to be more closely connected to western markets both through trade and through foreign investment. Both countries are very eager to strengthen their ties with the European Community by negotiating some form of associate status. Hungary has proposed putting its trade with the Soviet Union and the other CMEA countries on a convertible currency basis, and Czechoslovakia's Finance Minister, Václav Klaus, made the same proposal at the Sofia meeting of the CMEA. Some western participants thought such a proposal too costly, because the prices that these countries received for their exports of manufacturers to the USSR would fall sharply. Thus they suggested that current trading arrangements within the CMEA be reformed more gradually.

All participants agreed that foreign direct investment and tourism could make an important contribution to economic reform and urged favorable treatment of initiatives in these fields.

Convertibility was not seen as a viable option until macroeconomic stability could be assured and domestic prices rationalized. Until then limited convertibility, through hard currency auctions and the guaranteed convertibility of foreigners' profits, would be introduced.

Implications for the Future

Reformers in East Europe and their western advisors face a daunting challenge. The popular perception that market-oriented economies can be introduced as quickly as free elections is clearly false. There are many economic and legal issues that must be resolved before reasonably well-functioning markets can be established in the reforming countries. The path toward marketized economies will be slower than many expect, and the end result may be characterized by much more state ownership and market intervention than is to be found in western economies. Nevertheless, these reforms offer tremendous opportunities for western firms and an exciting challenge for western economists.

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ECONOMIC REFORM IN EASTERN EUROPE AND THE SOVIET UNION: SOFT FACTS NOT HARD NUMBERS ARE IMPORTANT

The Soviet Union and its erstwhile East European allies are all undertaking more or less radical reforms of their economies. The success of these reforms will shape the economic fortunes of the region for decades to come, and thus it is critical for us to judge whether the reforms are in fact succeeding. Evidence of success, however, is not to be sought in those traditional indicators, growth of income and production or the balance of trade and the growth of foreign debt, that so clearly demonstrated the failures of the traditional system of central planning. Much more critical in the short run will be less easily quantified information about the ability of the reforms to motivate workers and managers, to change expectations about the future, and to begin the process of restructuring and rationalizing the economy. Only once these programs have had several years of steady and consistent application will it make sense to look to traditional economic indicators for signs of improvement.

Poland. The one country where some numbers are of relevance is Poland. This is because Poland is the only country in the region to have held popular elections that put into power a party with the mandate to implement a fundamental reform.

The reform package was formulated in late 1989, and implementation began on January 1, 1990. Nevertheless, the reform had a valuable precursor, the freeing of prices, which led to rates of inflation as high as 600 percent. Although this inflation severely disrupted production, it had two valuable consequences. It wiped out hoards of cash that had been built up by consumers under the previous regime, and it led to a realignment of relative prices to better reflect relative costs and scarcities.

The first phase of the reform calls for a stabilization of the economy, largely by halting inflation by means of tough government fiscal and monetary policies. The government's budget deficit will be reduced through cuts in spending on defense and administration, and, more important, by sharply reducing subsidies on energy and food, as well as those directed toward loss-making firms. By 1991 the government should also obtain some help on the revenue side as a new VAT tax is introduced to replace the existing tax system which is increasingly less effective in collecting taxes either from enterprises or from the population. At the same, as this deflationary policy makes itself felt, the government's expenditures will rise to cover increased welfare payments to the population. Nevertheless, given the rudimentary nature of the Polish banking system, control over the budget deficit is the only effective way of limiting the growth of the money supply. The State Bank is cooperating by raising interest rates and by rationing credits to the enterprise sector.

The effects of this "big bang" contraction were immediate. Output in January fell by an estimated 20 percent and real wages in industry by about 30 percent, while unemployment rose to about 100,000, an unprecedented level. This deflation, combined with a tough incomes policy, held the price level fixed through the month, a sharp break with the hyperinflation of the past month.

Of course, one month's success in halting price increases is not enough. The battle now is to maintain the budgetary and credit policies that were responsible while simultaneously restoring the level of production by shifting resources to new sectors, a much more difficult problem. Hardest hit have been large enterprises producing consumer goods or products for export to the USSR. With sales of consumer goods within Poland falling, inventories have been building up, and unless either exports or domestic sales increase, some firms will have to curtail output and employment or even go bankrupt. Exporters to the USSR have also been hard hit by the new zloty-ruble exchange rate, which sharply reduces their profits.

If the government grants credits or subsidies to these firms, then its anti-inflation policy will be undermined, but given the lack of adaptability of these producers, the only alternative may be bankruptcy and unemployment. The official labor unions, that is the Communist-formed ones that have survived from the pre-Solidarity period, have become active advocates of price controls and generous unemployment benefits. There have also been some strikes, not only by workers, but also by pensioners and farmers. Nevertheless, the government's program continues to enjoy broad popular support as well as the cooperation of the IMF and its foreign creditors.

The government and its advisors realize that this popular support will evaporate if Poland remains stuck in a low inflation but low employment and income equilibrium for long. Given the inflexibility of the housing and labor markets, moving workers to new jobs will be difficult, as will the reconversion of large firms to the production of goods that can meet the test of the domestic, and more important, foreign market. Privatization of these firms will proceed slowly, in part because workers' councils at some enterprises are resisting the government's efforts and partly because the population lacks funds, and has no access to credit, with which to buy stock in these firms. As a result, the major force for privatization has been the emergence of small private businesses.

While the government's longer-range program for further privatization and marketization of the economy and for the creation of market-oriented institutions seems reasonable, the key to the success of the reform in the near-term is the ability of Polish industry to restructure its production and increase sales before either the economy collapses under the pressure of the government's deflationary policy or the government panics and attempts to reflate the economy too early, thus reviving all the inefficiencies and distortions of the old system. A key indicator that the latter option was being considered would be the resignation or sacking of Finance Minister Balcerowicz, a confirmed reformer.

Hungary. Unlike POland, Hungary has a caretaker government that has acted with energy, if not always with forethought, to eliminate many of the vestiges of Communist rule. Nevertheless, until a freely elected government is formed following the March 25 elections it is unclear what form Hungary's reform program will take. Unlike in Poland where Solidarity has maintained its unity, the Hungarian opposition is split into over 50 parties, representing a wide spectrum of views on how the economy should be reformed. Moreover, as the November, 1989 referendum showed, public support is shifting very rapidly among the major contending parties.

Whoever emerges as the winner in the elections, Hungary will most likely be ruled by a coalition government that will face some daunting problems. Hungary has endured 10 years of stagnation brought about by austerity policies that stifled growth without eliminating inefficient and outdated firms. As a result of this failure to bring about structural change, the country is reeling from one balance of payments crisis to another and may be forced to reschedule. Moreover, given Hungary's openness to the West, the population has high expectations regarding the level of prosperity that the new system should deliver.

The government's ability to control the economy has been undermined by past reform measures, which lifted the yoke of central planning but failed to replace it with the discipline of the market. Monetary policy has been tightened, but with little effect. Enterprises that were unable to obtain bank credit turned to self-financing by means of large inter-enterprise credits. The new commercial banks were unable to discipline the enterprises, largely because they feared for their own existence should their clients become illiquid.

Fiscal policy has also assumed a more deflationary stance, with the deficit falling from 6-7% of GNP to 3% in 1989. Nevertheless, revenues are likely to prove income-inelastic as the economy is increasingly privatized and as enterprises are increasingly forced to rely on their own resources. The government projects an inflation rate of 20 percent for 1990, which, by itself, will tend to make government expenditures rise more rapidly than revenues.

Like Poland, Hungary is likely to suffer from the disintegration of the CMEA and from the dislocations in the Soviet economy. A decline in exports will result either in subsidies or in unemployment, both worsening the government's deficit. A bright spot has been the interest shown by western firms in taking advantage of Hungary's privatization measures to purchase state-owned enterprises. General Electric's purchase of Tungsram, an important player on the world market for lightbulbs, is just the most noteworthy of these transactions. Nevertheless, Hungary cannot solve its problems by selling itself off to the West, and political resistance to the acceleration of foreign investments in forming. Thus the new government will have little time to formulate and implement an effective reform package.

Czechoslovakia. The issue of reform came to Czechoslovakia unexpectedly, with the sudden collapse of the Communist regime in late 1989. Indeed as late as September 1989 Czechoslovak economists had no reform model in mind and certainly no expectations that they would shortly be called upon to create one. Nevertheless, the circumstances for implementing a variable reform are good. Like Poland, Czechoslovakia is likely to emerge from the June elections with a large majority party, the Civic Forum, although other non-Communist parties are also likely to compete for votes. Moreover, the immediate economic situation in Czechoslovakia is good; inflation and macroeconomic disequilibrium are not serious problems, and the country's external debt is low.

The reform proposals currently being circulated within the government in draft form are very conservative. Their main objective appears to be to avoid the hyperinflation and disorganization that have hit neighboring Poland and Hungary. Thus the government intends to take a strongly deflationary stance by running a budgetary surplus, to be achieved by reducing defense spending, subsidies and government outlays on industrial investments. At the same time, it is expected that social security and welfare expenditures will be increased, although the overall goal is to gradually reduce the share of government spending in GNP. The State Bank is to support fiscal policy by keeping the growth of money supply below that of real GNP and by strictly controlling the lending of the newly-created commercial banks.

While there is a general consensus on the need for caution, this set of policies may prove difficult to implement. First of all, because Czechoslovakia is emerging from an entirely different economic system, the authorities have no basis on which to base their expectations of the macroeconomic effect either of a government surplus or a change in the money supply. Thus the policy stance adopted may lead to surprising results followed by panic among policymakers and ensuing instability in the formulation of policy. Second, the creation of commercial banks was carried out in a way that makes them ineffective tools of monetary control. This is because at their creation they were assigned specific enterprises as clients, and simultaneously they were given these enterprises debts, previously held by the State Bank. But many of these loans, often forced upon enterprises by central planners and not based on any assessment of whether they might even be repaid, are likely to go bad under a new price system and the elimination of state subsidies. The temptation will be for the commercial banks to issue further loans to these loss-making firms in order to prevent their collapse.

Part of the reason for a strong anti-inflationary stance is the recognition of a need to free prices so as to eliminate relative price distortions. Thus subsidies are to be cut to energy and food stuffs. At present there is considerable debate whether prices ought to be reformed at once or gradually over a period of 8-10 years.

The draft reformes are somewhat more adventurous with regard to privatization.. State enterprises will be turned into joint stock companies, with some shares sold to the public and to workers. Foreigners will also be eligible to purchase shares and even to acquire controlling interest partly through the sale of selected enterprises by means of competitive auctions. Foreign investors will also be free to start new corporations, which will be treated at least as well as domestic firms. A new law permitting the establishment of small scale businesses is also envisaged.

Although Czechoslovakia does not need foreign aid, either to deal with domestic shortages or to service its small foreign debt, expanded relations with the West are seen as critical for economic progress. Thus laws are being proposed to promote foreign investment, particularly in tourism and to rejuvenate Czechoslovakia's traditional industries in order to make them competitive on world markets through injections of western technology and marketing know-how.

While the relatively good macroeconomic situation in which the reformers find themselves is a plus, it has the danger of leading the planners into too slow a pace of reform. The population, having thrown the Communists out of power in a period of weeks may also want an economic reform that does not take 10 years to implement. Thus in the new, democratic politics that is emerging, the cautious slow-paced reform being proposed may become the political victim of an impatient electorate.

Romania. Although Romania experienced by far the bloodiest revolution in Eastern Europe, there is little likelihood of a fundamental economic reform along the lines of those in the countries discussed above. This is in large part because the removal of Ceasescu was something of a palace coup. That is, while the rage of the population, after years of privation unprecedented in any European country, was genuine, there are signs that public resistance was manipulated from within the regime to create the unrest that toppled Ceasescu. Thus the new government is formed largely of individuals who in the past held Party and government posts, though generally at levels such as Deputy Minister, that is to say, by technocrats who have come up through the ranks of the Party.

The current government thus has little interest in fundamental reform, and the early signs suggest that while there may be some decentralization of decisionmaking and possibly the creation of workers' councils in factories, Romania will remain a planned economy. Such a course is also dictated by the evident weakness of the government, which has been demonstrated both by dissention within its ranks and by public demonstrations against its rule.

In any case, abandoning Ceasescu's grandiose investment schemes and xenophobic policies should do much to restore normally to the economy and to revive the morale of the population. The fact that the country has no foreign debt coupled with the new government's evident desire to open the economy to foreign investment, both from the West and from other East European countries, represents an important plus in Romania's prospects.

Bulgaria. Reform in Bulgaria has been low key. On the political front, the Party has agreed to share power with the opposition. Proposals for minor economic tinkering, including a greater scope for cooperatives and small, privately owned firms as well as worker involvement in the selection of the managers of state-owned enterprises constitute the essence of reform proposals. In truth, Bulgaria is so closely tied to the USSR by means of bilateral trade agreements that more fundamental reform is impossible without a fundamental redirection of Bulgaria's trade. Since there appears to be little disagreement between the Party and the opposition on the need to maintain Bulgarian ties to the USSR, economic reform will continue to mean little more than tinkering with the existing system.

The Soviet Union. The other country where figures on economic performance will have some meaning in 1990 is the Soviet Union. In 1987 the Soviet Union adopted a major reform whose implementation began in 1988. The reform called for increased enterprise autonomy, a greater reliance on prices and financial signals and a liberalized foreign trade system. This reform has now been abandoned, partly a victim of its ill-thought out conception and of bureaucratic resistance but mainly as the result of the serious deterioration of the Soviet economy. This deterioration led not only to the abandonment of the reform, but also to the abandonment of the targets of the 12th Five Year Plan for its last year, 1990.

Economic performance in 1989 was clearly alarming to the Soviet leadership. National income produced grew at about 2.5 percent at "comparable" prices, though with estimates of hidden inflation ranging from 6 to 9 percent any estimate of real output growth must be treated with caution. More troubling were the qualitative aspects of economic performance. The state budget deficit increased to about 120 billion rubles fueling inflation and increasing the "ruble overhang" the unspent rubles in the hand of the population that have so far frightened the government into paralysis on the reform front. The inflationary effect of the deficit was reinforced by the growth of wages at a rate that exceeded labor productivity. Moreover, cuts in defense and investment were unable to offset this faster growth of incomes than of goods available for consumption. Shortages, queuing and rationing all increased and the quality of production showed no improvement.

Under these circumstances the government appeared relieved to be able to simply abandon the stalled reform movement and to turn to a stabilization program for 1990. This program, headed by Prime Minister Ryzhkov, calls for a sharp decrease in the budget deficit, to be engineered by reductions in capital, defense and administrative outlays as well as by reductions in subsidies to inefficient enterprises. Net material product is to increase by only 2 percent, but the supply of consumer goods is to grow much more rapidly, with production from existing facilities to be augmented by the reconversion of defense plants and imports from the West. Having placed his bets on perestroika's ability to improve the lot of the Soviet consumer. Gorbachev is now forced to rely on traditional methods of planning to stabilize the consumer goods market. Evidence that he is succeeding will come more from the reduction of shortages in the supply of consumer goods than from data about aggregate consumption.

The situation is not so serious that the economy cannot continue to limp along with output growth of 2 percent per year, but the new wave of reform measures, to be developed in 1991 and implemented in 1992 cannot be viewed as viable if, in the interim, the government is not able to gain control of its deficit and to begin to reduce the ruble overhang.

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